The Tax Planning For Expatriation From The United States

Course Level: Intermediate

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The taxation of Americans and long term green card holders (permanent residents) who expatriate from the United States has gone through many changes over the years. The latest version of these changes with tax expatriating Americans on their accumulated un-taxed wealth prior to their leaving the United States, along with their earned income that has not been paid and will be paid in the future.

In addition, the United States tax laws will tax expatriating Americans at draconian rates, for Americans that die owning United States wealth (the "Estate Tax") and that make significant gifts (the "Gift Tax") after they have given up their United States citizenship.

Tax planning is a must for all Americans who are planning to make the transition.

SUMMARY OF THE EXPATRIATION LAWS

Tax on Gain

Americans expatriating from the U.S. face several different U.S. taxes, when they expatriate and after they expatriate. These taxes apply to wealthy Americans who are referred as "Covered Expatriates".

Generally a tax is imposed a mark-to-market regime on wealthy expatriates by providing that all property owned by a covered expatriate is treated as sold on the day before the expatriation date for its fair market value. Any gain arising from the deemed sale is taken into account for the taxable year of the deemed sale notwithstanding any other provisions of the Code. Generally, any loss from the deemed sale is taken into account for the taxable year of the deemed sale to the extent otherwise provided in the Code. There is a minimum amount of gain that can be earned of $600,000, which amount is to be adjusted for inflation for calendar years after 2008 (the "exclusion amount"). A taxpayer may elect to defer payment of tax attributable to property deemed sold.

Tax on Compensation

The mark-to- market regime (1) does not apply to deferred compensation items, (2) specified tax deferred accounts, and (3) interests in a nongrantor trust of which the covered expatriate was a beneficiary on the day before the expatriation date.

However, there is a law that applies to "eligible deferred compensation items" and to other deferred compensation items ("ineligible deferred compensation items").

In the case of "eligible deferred compensation items," generally the payor of the compensation must deduct and withhold from any taxable payments to a covered expatriate with respect to those compensation items. This is a tax equal to 30 percent of the amount of those taxable payments. In the case of "ineligible deferred compensation items" a covered expatriate generally is treated as having received an amount equal to the present value of the covered expatriate's accrued benefit on the day before the expatriation date. Here the tax is delayed until payment of the deferred compensation.

If a covered expatriate holds any interest in a "specified tax deferred account" on the day before the expatriation date, such covered expatriate is treated as having received a distribution of the covered expatriate's entire interest in such account on the day before the expatriation date. Here the tax is delayed until payment of the deferred compensation.

If a covered expatriate has an interest in a trust, any direct or indirect distribution of property to a covered expatriate from a nongrantor trust of which the covered expatriate was a beneficiary on the day before the expatriation date will be taxed at 30% and the trustee must deduct and withhold from the distribution an amount equal to 30 percent of the taxable portion of the distribution. Furthermore, if the fair market value of the property distributed exceeds its adjusted basis in the hands of the trust, gain shall be recognized to the trust as if the property had been sold by the trust and the proceeds distributed to the covered expatriate.

THE COVERED EXPATRIATE

Covered Individual

An "Expatriate" means any U.S. citizen who relinquishes his or her citizenship. It also includes any long term resident of the United States who ceases to be a lawful permanent resident of the United States. ("Green Card"). This is limited to an individual who is a green cardholder for a minimum of 8 taxable years during the period of 15 taxable years that end and include the long term residents' expatriation date.

Exception to Covered Expatriate Rules

An expatriate will not be treated as a "covered expatriate"

1. if the expatriate had a second citizenship due to his or her birth; and on the expatriate date continues to be a citizen and tax resident of that other country, and has been a U.S. resident for not more than 10 taxable years during the 15 taxable year period prior to expatriation, or

2. the expatriate became at birth a U.S. citizen of another country and, as of the expatriation date, continues to be a citizen of, and is taxed as a resident of, such other country, and has been a U.S. resident for not more than 10 taxable years during the 15 taxable year period ending with the taxable year during which the expatriation date occurs; or

The Minimum Financial Requirements

There also is a minimum wealth and income requirement that must be met before an expatriate is subject to the expatriate taxes.

Any one of the following three factors will result in taxation.

1. The expatriate must have an average annual net income tax liability that for the five preceding taxable years ending before the expatriation date; that exceeds the specified amount of $124,000 that is adjusted for inflation, orThe expatriate must have a net worth of $2 Million or more as of the expatriation date (the "net worth test") or if

2. The expatriate does not certify under penalties of perjury that he or she has been in compliance with all U.S. Federal tax obligations for the five taxable years preceding the taxable year.

3. This means that the expatriate must have filed the proper income tax returns the day before the expatriation date.

There are exceptions to this definition.

Expatriation Date

The term "expatriation date" is the date an individual relinquishes U.S. citizenship or, in the case of a long term resident of the United States, the date on which the individual ceases to be a lawful permanent resident of the United States.

A citizen will be treated as relinquishing his or her U.S. citizenship on the earliest of four possible dates:

1. The date of the individual renounces his or her U.S. nationality before a diplomatic or consular officer of the United States pursuant the Immigration and Nationality Act

2. The date the individual furnishes to the United States Department of State a signed statement of voluntary relinquishment of U.S. nationality confirming the performance of an act of expatriation specified in the Immigration and Nationality Act.

3. The date the United States cancels a naturalized citizen's certificate of naturalization, or

4. If a long term resident ceases to be a lawful permanent resident because (i) the privilege of residing permanently in the United States as an Immigrant has been revoked or has been determined to have been abandoned, or if (ii) the individual either commences to be treated as a resident of a foreign country under the provisions of a tax treaty between the United States and the foreign country, and does not waive the benefits of the treaty applicable to residents of the foreign country, and notifies the Secretary of such treatment.

A taxpayer may elect to defer payment of tax attributable to property deemed sold under certain circumstances.

The Mark to Market Regime

The covered expatriate is deemed to have sold any interest in property that he or she is considered to own with certain exceptions. For purposes of computing the tax liability under the mark-to-market regime, a covered expatriate is considered to own any interest in property that would be taxable as part of his or her gross estate for Federal estate tax purposes, as if he or she had died on the day before the expatriation date as a citizen or resident of the United States. In addition, for this purpose, a Covered Expatriate also is deemed town his or her beneficial interest(s) in each trust (or portion of a trust), that would not constitute part of his or her gross estate as described in the preceding sentences.

In computing the tax liability under the mark-to-market regime, a covered expatriate must use the fair market value of each interest in property as of the day before the expatriation date in accordance with the valuation principles applicable for purposes of the Federal estate tax.

A covered expatriate must determine the fair market value of his or her beneficial interest in each trust, other than a nongrantor trust to the extent the trust would not be included in the expatriate's gross estate.

Allocation of the Exclusion Amount

There is exclusion for the first $600,000 adjusted for inflation. The exclusion amount must be allocated among all built in gain, property that is subject to the mark-to-market regime and is owned by the covered expatriate on the day before the expatriation date. Specifically, the exclusion amount must first be allocated pro rata to each item of built in gain property ("gain asset") by multiplying the exclusion amount by the ratio of the built-in gain with respect to each gain asset over the total built in gain of all gain assets. The exclusion amount allocated to each gain asset may not exceed the amount of that asset's built-in gain.

Each individual is eligible for only one lifetime exclusion amount. Thus, if a covered expatriate becomes a U.S. citizen or long-term resident, and then loses such citizenship or ceases to be a lawful permanent resident and thereby becomes a covered expatriate subject again, the exclusion amount with respect to the individual on a second expatriation is limited to the unused portion of his or her exclusion amount remaining (if any) after the first expatriation, as adjusted for inflation.

Adjustment to basis of Property Subject to the Mark-to-Market Regime

Proper adjustments are to be made in the amount of any gain or loss subsequently realized with respect to an asset for the amount of gain or loss taken with respect to that asset. In making such adjustment, the basis of this asset will be adjusted by the amount of gain or loss taken

In-Bound Step-Up in Basis for Nonresident Aliens Becoming Resident Aliens

A special rule applies for determining that tax on a nonresident alien, who becomes a resident after (Green Card Holder) and then later gives up their Green Card. Solely for purposes of determining the tax imposed by the expatriation tax, property held by a nonresident alien on the day that individual first became a permanent resident of the United States will be treated as having a basis on such date of not less than the fair market value of such property on such date. A covered expatriate to whom this basis adjustment rule applies may make an irrevocable election, on a property-by-property basis, not to have such rule apply.

Election to Defer Tax

Though the tax is incurred on gain on the deemed sale date, a Covered Expatriate may elect to defer the tax liability with respect to property subject to deemed sale treatment. The tax may be deferred until the taxable year the expatriate actually sells the disposition of the property.

The deferral cannot extend beyond the due date of the return for the taxable year in which the covered expatriate dies.

There are a number of conditions on the availability and cost of the deferral.

Interest will accrue on the deferred tax at the underpayment of tax rate;

B. Security must be provided with respect to the Property.

C. The covered expatriate must make an irrevocable waiver of any right under any tax treaty that would preclude assessment or collection of the tax; and a D. A U.S. agent must be appointed.

The election to defer taxes applies only to the specific property with respect to which it is made and irrevocable.

Adequate security/Tax Deferral Agreement. In order to make a deferral election with respect to any asset, the covered expatriate must provide adequate security with respect to such asset. The term "adequate security" means (1) a bond that is furnished to, and accepted by, the Secretary, that is conditioned on the payment of the tax (and interest thereon) or (2) another form of security for such payment (including letters of credit) that meets such requirements as the Secretary may prescribe.

Appointment of U.S. agent. In order to make a deferral election, a covered expatriate must appoint a U.S. person to act as the covered expatriate's limited agent for purposes of accepting communication related to the tax deferral agreement from the IRS on behalf of the covered expatriate.

DEFERRED COMPENSATION ITEMS

To mark to market regime applies to untaxed gains on property or essentially a tax on unrealized and unrecognized accretions to wealth. The tax under the mark-to-market regime does not apply to deferred compensation items. These items on income are subject to a different method of taxation.

Compensation is considered to be "eligible deferred compensation items" or "ineligible deferred compensation items".

Deferred compensation items are interests in retirement plans, compensation for services that are subject to tax deferral and any other items of deferred compensation. Deferred compensation items are divided into two categories, eligible and non-eligible. For eligible deferred compensation items, there is no deferred sale. Instead there is a 30% tax that is withheld by the payors when the taxable deferred compensation items are paid.

An "item of deferred compensation" is any amount of compensation if, under the terms of a plan, contract or other arrangement providing for such compensation (compensation arrangement), the Covered Expatriate has a legally binding right as of the expatriation date to such compensation; the compensation has not been actually or constructively received on or before the expatriation date; and pursuant to the compensation arrangement the compensation is payable to (or on behalf of) the covered expatriate on or after the expatriation date.

In the case of an "eligible deferred compensation item;" the U.S. payor of the deferred compensation must deduct and withhold a tax equal to 30 percent of any taxable payment to a covered expatriate with respect to such an item.

Eligible deferred compensation items require the tax to be paid as the deferred compensation is paid and that it be in the form of a 30% withholding tax for which the payor is responsible.

Ineligible Deferred Compensation

IN THE CASE OF "INELIGIBLE DEFERRED COMPENSATION ITEMS" A COVERED EXPATRIATE GENERALLY IS SUBJECT TO TAXATION ON THE INELIGIBLE DEFERRED COMPENSATION ITEM AS IF RECEIVED BY THE COVERED EXPATRIATE ON THE DAY BEFORE THE EXPATRIATION DATE WHETHER IT HAS BEEN IN FACT RECEIVED OR NOT.

In General

In the case of "ineligible deferred compensation items," the law provides that a covered expatriate generally is subject to taxation on the ineligible deferred compensation item as if received by the covered expatriate on the day before the expatriation date.

Taxation of Eligible Deferred Compensation Items

If a deferred compensation item qualifies as an eligible deferred compensation item, the payor must deduct and withhold a tax equal to 30 percent of any taxable payment to a covered expatriate with respect to such an item. The law provides that a taxable payment is any payment to the extent it would be includible in gross income of the covered expatriate if such person continued to be subject to tax as a citizen or resident of the United States. Because the covered expatriate must waive his or her right to claim treaty benefits with respect to an eligible deferred compensation item, the 30 percent withholding tax cannot be reduced or eliminated by treaty. However, an amount of deferred compensation that is attributable to services performed outside the United States while the covered expatriate was not a citizen or resident of the United States is not subject to this tax.

Taxation of Ineligible Deferred Compensation Items

With respect to any ineligible deferred compensation, an amount equal to the present value of the covered expatriate's accrued benefit is treated as having been received by the covered expatriate on the day before the expatriation date as a distribution under the plan and must be included on the covered expatriate's U.S. individual tax return for the portion of the taxable year that includes the day before the expatriation date.

The person paying the ineligible deferred compensation item must advise the covered expatriate of the present value of the covered expatriate's accrued benefit to the deferred compensation item on the day before the expatriation date.

In the case of certain defined contribution plans, until further guidance is issued, the present value of the covered expatriate's accrued benefit is the account balance.

Deferred compensation items include: (1) any interest in a plan or arrangement described in Section 219(g)(5); (2) any interest in a foreign pension plan or similar retirement arrangement or program; (3) any item of deferred compensation; and (4) any property or right to property, which the individual is entitled to receive in connection with the performance of services to the extent not previously taken into account under Section 83 or in accordance with Section 83.

The "specified tax-deferred accounts" are the following: (1) an individual retirement plan, other than any arrangement described in Section 408(k) or (p); (2) a Section qualified tuition program; (3) a Section 530 Coverdell education savings account; (4) a Section 223 health savings account; and (5) a Section 220 Archer MSA. A covered expatriate is required to treat these accounts as being entirely distributed on the day before the date of the expatriation , thus terminating the accounts. However, no early distribution tax is to apply by reason of this treatment.

Trust Distributions

Rather than being deemed sold or distributed, a grantor trust interest treated as owned by the expatriate, is subject to withholding and payment by the trust of a 30% tax on the "taxable portion" of actual distributions when they occur. The determination of whether and how much of a trust is not treated as a grantor trust is made immediately before the date of expatriation and the taxable portion of the each distributing is the portion that would be includible in the covered expatriate's gross income if such expatriate had continued to be a U.S. citizen or resident. The covered expatriate is treated as waiving any reduction in withholding under a U.S. treaty unless the covered expatriate agrees to such other treatment as the IRS may require.

In addition, if the fair market value of any distributed property exceeds its adjusted basis in the hands of the trust, gain must be recognized to the trust as if such property were sold to the expatriate as its fair market value.

Estate and Gift Taxation under Section 877A

If a U.S. citizen or resident receives property directly or indirectly either by or from, or by reason of the death of, a person who at the time of the acquisition or death was a covered expatriate, then the transfer is subject to a tax equal to the value of the property multiplied by the highest rate of tax for federal estate tax or federal gift tax purposes. The tax is payable by the recipient.

For purposes of Section 2801, there are reductions in the value for a gift in the amount of the annual gift tax exclusion although there is no unified credit amount in the case of a transfer by reason of death.

There are, however, also exceptions for transfers reported on a timely filed return and otherwise subject to federal estate or gift tax and for a transfer to a spouse or charity that would qualify for a deduction if the donor or decedent were a U.S. person. The amount of the tax is also subject to reduction for any gift or estate tax paid to a foreign country with respect to the property transfer. Finally, there are special rules treating a domestic trust as a U.S. citizen for this purpose (with the tax being payable by the trust) and treating distributions from a foreign trust as a U.S. citizen or resident as taxable (with an election available to the foreign trust as treated as a domestic trust).

Ineligible

With respect to any ineligible deferred compensation item not described in section of this notice, until further guidance is issued, the present value of the covered expatriate's accrued benefit is determined by applying principles in Prop. Treas. Reg. Section 1.409A-4, except as provided herein.

Where such proposed regulations provide for a determination to be made as of the end of the taxable year, such determination shall be made as of the day before the expatriation date. For the purposes of this section, the present value of the covered expatriate's accrued benefit is determined without regard to any substantial risk of forfeiture.

FILING AND REPORTING REQUIREMENTS

Income tax returns

Initial filing obligations for the year of expatriation. A covered expatriate tax must file a dual status return if he or she was a U.S. citizen or long term resident for only part of the taxable year that includes the day before the expatriation date. A dual status return requires the covered expatriate to file a Form 1040NR with a Form 1040 attached as a schedule. If the covered expatriate's expatriation date is January 1, then he or she will not be required to file a dual status return.

Filing obligations for subsequent years.

A covered expatriate must file Form 1040 NR. If the covered expatriate tax is fully withheld upon at source for a particular taxable year and has no income effectively connected with the conduct of a trade or business in the United States for that year, then he or she will not be required to file a Form 1040NR for those years.

NOTICES TO PAYORS

Form W-8CE Notice to Payor

A covered expatriate who has a deferred compensation item, a specified tax deferred account or an interest in a nongrantor trust must file Form W-8CE with the relevant payor on the earlier of (1) the day prior to the first distribution on or after the expatriation date or (2) 30 days after the covered expatriate's expatriation date as defined in section (3).

Eligible deferred compensation item. In the case of an eligible deferred compensation item, the Form W-8CE provides notice to the payor that the individual is a covered expatriate who has waived treaty benefits with respect to the eligible deferred compensation item, with the result that taxable payments will be subject to 30 percent withholding.

Ineligible deferred compensation item.

In the case of an ineligible deferred compensation item described in section, Form W-8CE provides notice to the payor that the individual is a covered expatriate who is treated as receiving an amount equal to the present value of his or her accrued benefit on the day before the expatriation date and with respect to which appropriate adjustments must be made to subsequent distributions to reflect the tax imposed by reason of such treatment. Within 60 days of receipt of Form W-8CE, the payor must provide a written statement to the covered expatriate setting forth the present value of the covered expatriate's accrued benefit on the day before the expatriation date.

Specified tax deferred account.

In the case of a specified tax deferred account, Form W-8CE provides notice to the payor that the individual is a covered expatriate who is treated as receiving a distribution of his or her entire interest in the account on the day before his or her expatriation date and with respect to which appropriate adjustments must be made to subsequent distributions to reflect the tax imposed by reason of such treatment. Within 60 days of receipt of Form W-8CE, the payor must provide a written statement to the covered expatriate settling for the amount of the covered expatriate's account balance on the day before the expatriation date.

Interest in Nongrantor trust.

In the case of an interest in a nongrantor trust of which the covered expatriate was a beneficiary on the day before the expatriation date, Form W-8CE provides notice to the trustee that the individual is a covered expatriate. The covered expatriate will be deemed to have waived treaty benefits with respect to future distributions from the trust unless the covered expatriate checks a box on Form W-8CE certifying that he or she will elect on Form 8854 to pay tax currently on the value of his or her interest in the trust.

TRANSFER TAX ON GIFTS AND BEQUESTS RECEIVED FROM COVERED EXPATRIATES

Congress has tried in vain on several occasions to tax gifts and estates of expatriate Americans.

The new regime makes another attempt at this. **If a U.S. citizen or resident receives a covered gift of bequest from a covered expatriate (including a distribution from the income or corpus of a foreign trust attributable to a covered gift or bequest made to a foreign trust), the transfer is subject to tax.**

A "covered gift or bequest is property" acquired directly or indirectly by gift from, or by reason of the death of, a person who at the time of the acquisition or death was a covered expatriate. A covered gift or bequest does not include (1) a taxable gift by a covered expatriate if reported on a timely filed gift tax return; (2) property included in a covered expatriate's gross estate and reported on a timely filed estate tax return; and (3) transfers to which an estate tax charitable deduction or a gift tax or estate tax marital deduction would be allowable if the donor or decedent were a U.S. person.

The tax, which is payable by the recipient, is equal to the value of the gift or bequest multiplied by the highest estate tax rate or, if greater, the highest gift tax rate. The tax is imposed only to the extent the recipient receives covered gifts and bequests during the calendar year valued in excess of the annual gift tax exclusion. The tax on a covered gift or bequest is reduced by any foreign gift or estate tax paid on such gift or bequest. THE TAX IS NOT REDUCED BY THE GIFT TAX UNIFIED CREDIT OR THE ESTATE TAX UNIFIED CREDIT.

TAX PLANNING - GREEN CARD HOLDERS – DO THEY NEED THE GREEN CARD

A green card as opposed to a temporary visa of one sort or another, which may achieve the same ends, in substance, while avoiding the green card. If one is able to stay in the United States for the desired duration without tripping the eight year/15 year wire, he or she will have much more flexibility when transferring his or her wealth. And, depending on the circumstances, of course, one must consider leaving the United States before the culmination of eight years of residency – especially if there is no plan to return.

Income Stream

If an NRNC cannot be dissuaded from obtaining a green card, and likely is staying for at least eight years in the United States but will give up U.S. residency (upon retirement or a child's graduation, for instance), and e.g. will leave U.S. gift recipients and/or U.S. beneficiaries behind, then transferring assets before entering the United States would clearly avoid both the general transfer tax limitations on U.S. citizens/residents and the Section 2801 tax. Discussing pre-immigration transfers is absolutely vital as an NRA can make unlimited transfers of non U.S. situs assets with virtually unlimited flexibility – subject to none of the limitations vis a vis the FET exemption, lifetime FGT exemption, annual gift tax exclusion and marital deduction. Once the NRNC establishes a domicile in the United States, he or she will most likely need many years' worth of exemptions and exclusion amounts to transfer what could have been transferred in one year as an NRA.

A major silver lining to the HEART Act is that U.S. residents who are no green card holders are no longer subject to any transfer tax consequences when they exit the United States.

For those who have been in the United States for many years with a green card, a simple change in immigration status may also prove to be important estate planning. Such people may indeed want to consider becoming and remaining U.S. citizens, for instance – to avoid the exit tax when leaving the United States while still have the ability to live abroad and use the normal rules (including any transfer tax treaties for avoiding double transfer taxation.) Or they may consider giving up the green card before the eight year trigger pulls and remain in the United States on a temporary visa.

U.S. citizens that wish to expatriate and avoid the HEART Act's expatriation tax regime have far fewer options – other than to just fade away. An option in some circumstances is to make exemption sheltered, pre expatriation gift(s) to reduce the subject's net worth until it is under the net worth threshold (this is effective, assuming he or she would also be underneath the tax liability threshold and able to make the compliance certification), therefore preventing application of the rules in the first place. Similarly, another possibility is to time the expatriation when the valuation of the worldwide assets is lowest (in a down market for example). In any case, it involves numbers crunching and, in many cases, the cost of the exit and/or inheritance taxes now or later will be less than a lifetime of the various taxes suffered as a U.S. citizen. And a related, final note is that, in a lot of cases, the expatriation inclined person would do well to take the plunge now rather than wait for Congress to further tinker with the rules, which history teaches is only a matter of time.

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Richard has received the highest rating (AV-rated) for legal ability and ethical standards from Martindale-Hubbell. Richard Lehman believes *"The best rule to follow in the field of tax law is to plan legal matters and obtain precision advice in advance to insure commercial endeavors are completed at minimum tax costs and personal lives are minimally disrupted."*

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