

Taxation of the Expatriating Client

The taxation of expatriates has undergone significant changes in recent years, which has made a set of complex laws even more complicated when it comes to advising clients who have expatriated from the United States, or who are considering doing so. While the number of people who expatriate from the U.S. is still relatively low, our office has recently advised a couple of long term U.S. resident clients who were contemplating returning to their countries of origin. As these situations arise, it is critical that a thorough analysis of potential income, gift and estate tax issues be undertaken. The goal of this Article is to provide an overview that will be helpful to practitioners attempting to evaluate tax issues that may exist for clients contemplating expatriation as well as for those who have already expatriated.

The term “expatriate” refers to (1) citizens of the U.S. who give up their citizenship, and (2) long term U.S. residents who relinquish their residency after have legally resided in the U.S. for at least 8 of the last 15 years preceding the tax year at issue. Because of this definition, and given the potential tax consequences of expatriation that will be discussed in the Article, it may make sense to advise a client who has legally resided in the U.S. for less than 8 years to expatriate before the 8 year mark if they are seriously considering expatriation.

This Article will now turn its attention to old and new rules relates to income, gift and estate taxation of certain expatriates.

Income Taxation of Expatriates

The income tax law applicable to expatriates was originally set forth in Section 877 of the Internal Revenue Code of 1986, as amended. This statute was replaced, however, and since June 16, 2008, the applicable law is set forth in Section 877A of the Internal Revenue Code of 1986, as amended, otherwise known as the “HEART Act”. When Section 877A was adopted in 2008, certain principles were carried over from Section 877. Therefore, a discussion of the application of Section 877 provides historical context for understanding application of Section 877A. In addition, Section 877 is still the applicable law that applies to income taxation of persons who expatriated before June 16, 2008.

The Old Regime *Section 877*

Under Section 877, it was easy to determine expatriates who were former U.S. citizens who had given up their citizenship. It was more difficult to determine whether application of Section 877 was appropriate for long-term residents, especially since this Section applied only to certain long-term residents. As mentioned, a long term resident was defined in Section 877 as persons who lived in the U.S. legally under a green card

for at least 8 of the 15 years preceding the year of tax imposition. An expatriate was considered a “Covered Expatriate” if any of the following requirements were satisfied:

1. The average annual net income tax liability of the expatriate for 5 years preceding expatriation exceeded \$124,000.00 (adjusted for inflation for tax years subsequent to 2004);
2. The expatriate’s net worth was greater than \$2,000,000.00 dollars (an exception was made for dual citizens); or
3. The expatriate failed to certify to the US Treasury that he/she complied with all US federal tax obligations for the 5 years preceding expatriation.

To make matters even more complicated, if an expatriate did not fall within any of these three categories, he or she would still have been considered a Covered Expatriate under Section 877 if the purpose of expatriation was to avoid U.S. taxation. To avoid this outcome, expatriates who did not fall within any of these three categories would have been wise to submit a request to the IRS for confirmation of exemption from Section 877 within one year of expatriation.

A long term resident who otherwise would have been subject to taxation under Section 877 as a covered expatriate, was not subject to U.S. taxation for a year in which he or she was a resident of a foreign country that had an existing tax treaty with the U.S., provided the benefits of the treaty had not been waived by the covered expatriate.

Alternate Tax Regime: Section 877 created an alternative tax regime for covered expatriates. Under Section 877, the term “Alternative Tax Regime” means that covered expatriates are subject to tax on U.S. source income at rates applicable to U.S. citizens for a period of **10 years** following their date of expatriation, but only to the extent of U.S. source income, and only if the Alternative Tax Regime produced a higher tax liability for the expatriate than would have been imposed for a non-resident alien. Therefore, two tax calculations were necessary to determine which produced the higher tax liability.

“U.S. Source income”, as defined under Section 877, refers to investment income and income connected with a US Trade or business, gains on the sale or exchange of real property located in the U.S., and gains on the sale or exchange of stock issued by a domestic corporation or bonds issued by a U.S. corporation or a government located within the U.S. A special gain recognition rule prevents an expatriate subject to Section 877 from making a tax free exchange of US property for foreign property and, subsequently, selling the foreign property free and clear of U.S. tax. U.S. income tax liability stays with such foreign property, although enforcement is obviously very difficult.

The New Income Tax Regime
Section 877A

When Section 877A became law in 2008, it created a new income tax regime for covered expatriates. As with Section 877, Section 877A applies both to U.S. Citizens who give up their citizenship, as well as to long term non-citizens who relinquish their residency after having lived in the U.S. legally under a green card for at least 8 of the 15 years preceding the tax year at issue. While there are exceptions for some individuals who have had dual citizenship from birth, and for individuals who relinquished their citizenship prior to attaining the age of 18 1/2, there are no similar exceptions for long-term residents. Whether or not the primary purpose of expatriation was to avoid U.S. taxation is no longer relevant in determining whether an expatriate is a covered expatriate for purposes of Section 877A.

Similar to Section 877, Section 877A applies to an expatriate only if:

1. The average annual net income tax liability of the expatriate for the 5 years preceding his or her date of expatriation exceeds \$145,000 as of 2009 (indexed for inflation);
2. The expatriate's net worth exceeds \$2,000,000 dollars on his or her date of expatriation; or
3. The expatriate fails to certify to the U.S. Treasury under penalty of perjury that he or she has complied with all U.S. federal tax obligations for the 5 years preceding the date of expatriation.

If an expatriate falls within one of these categories, he or she is referred to as a "covered expatriate" not only for purposes of income taxation under Section 877A, but also for purposes of estate and gift taxation under Section 2801, which is discussed in detail below.

Mark to Market Rule Adopted

With the adoption of Section 877A, there is now a new method of taxing the income of a covered expatriate. Rather than being subject to tax on U.S. source income for a period of 10 years after expatriation, covered expatriates are now subject to mark to market taxation rules. Generally, all property owned by a covered expatriate is treated as being sold for its fair market value on the day before the date of expatriation. There are exceptions for certain types of property, which are discussed below. The location of the property in the U.S. is not required. Property located anywhere throughout the world is covered. The mark to market tax is also referred to as the "Exit Tax".

The following rules were adopted with regard to the implementation of mark to market taxation of this property:

1. Proper adjustment must be made in the amount of gain or loss subsequently realized upon actual sale of the property.
2. An applicable exclusion amount of \$600,000.00 (adjusted for inflation for tax year following 2008) may be applied towards any actual gain on the subsequent sale of the property, but in no event is the gain reduced below \$0.
3. The capital gains rate is the current rate in effect, i.e., now 15%, provided that the asset is a capital asset in the hands of the expatriate and he or she held the asset for more than 1 year prior to the sale. Rates of 25% and 28% apply in the case of certain real estate and collectibles.
4. If property was owned by the expatriate on the date he or she became a resident of the U.S., the basis of the property may not be less than the fair market value of such property on the day the expatriate became a resident (unless elected otherwise by irrevocable election). The basis of property acquired after becoming a U.S. citizen or resident is the cost of the property.

Commentators have been struck by the lack of attention that appears to have been given to coordinating this new mark to market approach with U.S. tax treaties. In addition, Section 877A provides no foreign tax credit for income taxes paid to another country, and it is not clear how possible double taxation issues will be addressed under Section 877A.

Deferral of Mark to Market Taxation: A taxpayer may elect to defer mark to market taxation until the due date for the income tax return covering the taxable year in which such property is disposed of. The expatriate must pay interest and must supply adequate security in order to receive tax deferral, although little guidance is given for what constitutes adequate security. The deferred tax under Section 877A must be paid no later than the due date of the tax return for the tax year in which the property is disposed of, and may not be extended beyond the due date of the income tax return for the year of the expatriate's death. In order to receive mark to market tax deferral, the expatriate must waive his or her rights under any tax treaty that would otherwise preclude assessment of mark to market taxation under Section 877A.

Property Exempt from Mark to Market Taxation

There are exceptions to application of mark to market taxation for the following types of property: (1) Eligible deferred compensation plans or arrangements; (2) specified tax deferred accounts, and (3) any beneficial interest in a non-grantor trust held by the expatriate on the day before expatriation.

(1) Deferred Compensation Item: A Deferred Compensation Item refers to any interest in an eligible deferred compensation item that is described in Section 219(g)(5), an interest in a foreign pension plan, any item of deferred compensation, and any property, or right thereto, which a person is entitled to receive in connection with the performances of services to extent such property is not covered by Section 83.

The rules described in this Article do not apply to deferred compensation items attributable to services performed outside the U.S. while the individual was not a U.S. citizen or resident.

To be an Eligible Deferred Compensation Item, and therefore exempted from mark to market taxation, the Payor of such item must be a U.S. person or a person who is not a U.S. person, but who elects to be treated as a U.S. person for purposes of 877A, and meets such other requirements as may be mandated by the U.S. government. The expatriate must also notify the Payor of his status as a covered expatriate.

If the Deferred Compensation Item is deemed eligible, the Payor of the income must withhold a 30% tax from any taxable payment, which is defined as payment that would have been includible in income if made to a US citizen or resident. The covered expatriate must make an irrevocable waiver of any right to claim any withholding reduction on this item under any treaty with the U.S.

If a deferred compensation item is not eligible for such tax treatment, an amount equal to the covered expatriate's accrued benefit is treated as having been received by that individual on the day before the expatriation date. Early distribution penalties do not apply, and appropriate adjustments are made to subsequent (actual) distributions from the account to reflect prior taxation.

(2) Tax Deferred Accounts: Tax deferred accounts are defined as any individual retirement plan (defined in code Section 7701(a)(37)) **other than**: (1) a plan described in Sections 408(k) (a simplified employee pension) or 408(p) (simplified retirement account), (2) a 529 plan, (3) a Coverdell education account, (4) a health savings account, or (5) an Archer MSA.

Tax Deferred Accounts not specifically exempted under the preceding paragraph are instead treated as if the expatriate received a distribution of the entire account on the day before his or her expatriation date. Early distribution penalties do not apply, and appropriate adjustments are made to subsequent (actual) distributions from the account to reflect prior taxation.

Tax Deferred Accounts specifically exempted are taxed according to separate rules. For example, simplified employee pensions and simplified retirement accounts are subject to the tax rules for Deferred Compensation Items (described above).

(3) Beneficial Interest in a Non-Grantor Trust: With regard to ownership of a beneficial interest in a non-grantor trust by an expatriate on the day before his or her expatriation, the Trustee must deduct and withhold from a distribution to a covered expatriate an amount equal to 30% of the taxable portion of the distribution and, if the fair market value of such property on the day before expatriation 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 at its fair market value. The taxable portion of a distribution is the portion of the distribution, which would be includible in the gross income of the

covered expatriate if he or she remained subject to tax as a U.S. citizen or resident. The covered expatriate is treated as having waived any right to claim any withholding reductions under a U.S. tax treaty on any distributions subject to this withholding rule, unless the covered expatriate and the IRS agree to an alternate arrangement. There appears to be no limit on the duration of the withholding in the case of a Non-Grantor Trust with a long lifespan.

The Estate and Gift Tax

As with the income tax, there have been recent changes in the areas of estate and gift tax as they apply to covered expatriates. The following discussion will focus on these tax rules as they apply to two groups of expatriates; those who expatriated prior to or on June 16, 2008 and to those who expatriated after June 16, 2008. The date of expatriation is critical to determining which rules apply. While the HEART Act eliminated application of code sections 2107 (estate taxation of expatriates) and 2501(a)(3) (gift taxation of expatriates) to those expatriating after June 16, 2008, it did not eliminate their application to those who expatriated on or before June 16, 2008. As will be discussed, the HEART Act also imposes a potential new tax on U.S. citizen or “resident” transferees of gifts or bequests from a covered expatriate under Section 2801.

Estate Taxation Rule Applicable to Covered Persons who Expatriated on or before June 16, 2008

For persons who expatriated on or before June 16, 2008, Section 2107 imposed Federal Estate Tax according to the following criteria:

1. Section 2107 considers as domiciled in the U.S. for estate tax purposes a covered expatriate who dies in a year in which he was present in the U.S. for 30 or more days (not including days performing services for an employer) within the 10 year period following the date of expatriation;
2. In such a case, Section 2107 imposes a U.S. estate tax on the decedent’s estate and an expanded definition of gross estate must be used. This definition includes not only property of the deceased expatriate situated in the U.S. (real, tangible and intangible), but also the proportion of the value of U.S. property held in a foreign corporation if the deceased expatriate owned at the time of his or her death: (1) 10% or more of the total combined voting power of all classes of stock entitled to vote; or (2) 50% or more of the total combined voting power of all classes of stock entitled to vote, or 50% or more of the total value of the stock of such corporation;
3. Section 2107 imposes the same estate tax rate that applies to a U.S. citizen who dies in that same year;
4. The unified credit applies, but it is limited to \$13,000; and
5. Credit is given for any foreign estate or inheritance taxes assessed against the same property included in the expatriate’s estate under Section 2107, but there are limitations to this credit under Section 2107(c).

Gift Taxation Rules Applicable to Covered Persons who Expatriated on or before June 16, 2008

The gift tax rules applicable to covered persons who expatriated on or before June 16, 2008 are contained in Section 2501 and provide as follows:

1. Special gift tax rules apply for 10-year period following the date of expatriation.
2. Gift taxes are imposed on citizens, residents and non-residents on gifts they make of real property, tangible personal property and intangible property situated in the U.S.
3. An expanded definition of property applies, which includes not only gifts of property described in Section 2501 (U.S. situs property), but the proportion of the value of U.S. property held in a foreign corporation if the expatriate owned at the time of the gift of stock of such corporation: (i) 10% or more of the total combined voting power of all classes of stock entitled to vote; or (ii) 50% or more of the total combined voting power entitled to vote, or 50% or more of the total value of the stock of such corporation.
4. If the covered expatriate makes a gift within the calendar year that he or she is present in the U.S. for 30 days or more (not including days performing services for an employer) during the 10 year period following the date of expatriation, then he or she is treated as being domiciled in the U.S. for gift tax purposes and all gifts made during such calendar year will be subject to U.S. gift tax regardless of the situs of the gifted property.

Application of the Gift and Estate Tax for Covered Persons Expatriating after June 16, 2008

Under the HEART Act, a U.S. citizen or resident transferee of bequests or gifts from a covered expatriate may be subject to tax on such property under Section 2801. This is true regardless of the value of the property transferred or the total value of all of the expatriate's assets, wherever located, on the date of expatriation or on the date of death. The rate imposed on the recipient is the higher of the applicable estate or gift tax rate at the time of the transfer. Therefore, even though there is no estate tax currently in effect for 2010, and assuming that no estate tax is imposed retroactively to January 1, 2010, there still would be a tax imposed under Section 2801 on property gifted or bequeathed to a U.S. citizen or resident at the 35% gift tax rate in effect for 2010.

Section 2801 imposes the tax created therein on a transferee who is considered to be a "resident" for purposes of such section, and who receives property in the form of a gift or bequest directly or indirectly (via a trust) from a covered expatriate as such term is defined in Section 877A. A U.S. citizen would qualify as a "resident" under the section regardless of whether or not such citizen is domiciled in the U.S. at the time of the gift or bequest. For a non-citizen resident, it appears as though the transferee must be "domiciled" in the U.S. for federal estate and gift tax purposes in order for the

tax of Section 2801 to be imposed on the transferee. Note that a U.S. tax treaty will not be effective in reducing or eliminating the transfer tax because it is the U.S. citizen or resident transferee, not the expatriate transferor, who is subject to the tax.

Trusts do not escape imposition of the Section 2801 tax. Domestic trusts must pay the tax on bequests or gifts made to the trust in the taxable year of the bequest. Unlike domestic trusts, foreign trusts do not pay the tax. Rather, it is imposed on the U.S. citizen or resident beneficiary who receives distribution of the assets bequeathed or gifted to the foreign trust. Payment of the tax is deferred until the year of distribution to the beneficiary. The foreign trust may elect, however, to be taxed upon the bequeathed or gifted funds or property in the same manner as a domestic trust, but such election is irrevocable once made unless the U.S. government consents to revocation.

A beneficiary of a foreign trust can take a Section 164 deduction on property distributed from the trust that is included in the beneficiary's gross income to the extent the beneficiary is also subject to Section 2801 transfer tax on the distributed property.

There are certain provisions, which will reduce or eliminate application of the Section 2801 tax:

1. Transfers from an expatriate to his or her spouse qualifying for a deduction under Section 2056 are not subject to tax under Section 2801;
2. Transfers that do not exceed the current annual exclusion under Section 2503(b) are not subject to tax under Section 2801;
3. Transfers of property that are subject to gift or estate tax under the laws of a foreign country are not taxable under Section 2801 up to the amount of such tax paid in that foreign country (even if the tax is not paid by the transferee);
4. Transfers to qualifying charities are not taxable under Section 2801; and
5. Transfers of bequeathed or gifted property included on a timely filed U.S. estate or gift tax return are not subject to tax under Section 2801.

More guidance is needed on the timing, calculating, reporting and paying of tax on covered transfers under Section 2801. The IRS intends to issue guidance on Section 2801 as well as a new Form 708 on which to report the receipt of gifts or bequests from a covered expatriate.

Conclusion

While many of us have never encountered, or have rarely encountered, expatriation tax issues in our practices, it is certainly possible that we will come across issues related to taxation of expatriates at some point in the near future. For example, students who come from abroad to study in the U.S. may exceed the 8-year legal residence threshold if they undertake both undergraduate and graduate course work, or if they stay in the US to work after graduation. We also live in an increasingly global world in which people live, study and work outside of their country of origin. I hope that this Article has provided a helpful overview, and that it can be used as a starting point for

assessing potential tax liabilities facing a client who has expatriated, or for advising a client who may be weighing the costs and benefits of expatriation.

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