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U.S. Adopts Exit Tax Upon Expatriation*

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With the passage of the Heroes Earnings Assistance and Relief Tax Act of 2008 (“the HEART Act”) on June 17, 2008, circumstances changed drastically for those individuals who were planning to give up their US citizenship and for long-term US residents who were planning to give up their green cards. This act, with its veto-proof name, was designed to provide tax relief for US soldiers. In order to pay for this relief, Congress imposed a new “exit tax” on Americans seeking to revoke their US citizenship.

The United States taxes its citizens on their worldwide income. The only way US citizens can legally avoid paying US taxes is to expatriate. Under the old expatriation regime, expatriates continued to be subject to US taxation on an expanded class of US-source income for 10 years after the date of their expatriation. With careful planning, however, it was usually easy to avoid taxation during the 10-year period, unless you died.

Now, rather than being subject to a 10-year alternative income tax regime on US-source income and effectively connected income, after which expatriates would be virtually free from US taxation on built-in gains that they successfully postponed triggering, such taxation cannot be avoided, and, worse yet, is imposed immediately. There is no “tax-avoidance” motive requirement; anyone expatriating from the United States for any reason is potentially subject to the tax. The taxpayer so snared is subject to an immediate tax on a deemed sale of all his or her worldwide assets on the day immediately prior to the date of expatriation. The old regime has been entirely repealed and replaced with this new “exit tax” regime for taxpayers who expatriate on or after June 17, 2008.

The philosophy behind the new regime is unquestionably logical – to tax expatriates on the unrealized appreciation of their property that accrued while they were US persons. For those contemplating leaving the US, while there are several advantages in the rules implementing the new regime, there are also certain disadvantages. This new system is infinitely simpler, but the ability to avoid tax merely by remaining alive and delaying sales of appreciated assets for more than 10 years no longer exists. The old regime, however, limited the time that an expatriate could

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spend in the United States during the 10-year period after expatriation to 30 days or less each year; beyond this limit, the expatriate would be treated anew as a citizen or a long-term resident. The new rules have removed this restriction and instead rely on the general “substantial presence test”¹ to render an expatriate a US resident again, for federal tax purposes.

I. Who is subject to the new regime?

The new regime is applicable to individuals referred to in the Code as “covered expatriates.” A covered expatriate is any US citizen who relinquishes citizenship or any long-term resident who terminates US residency, if such individual: (1) has an average annual net income tax liability for the five years immediately preceding the deemed expatriation that exceeds \$139,000² (“the net income tax liability requirement”); (2) has a net worth of \$2 million or more on the date of expatriation (“the net worth requirement”); or (3) fails to certify under penalties of perjury that he or she has complied with all US federal tax obligations for the preceding five years or such other evidence as the Secretary³ may require.

A US citizen is treated as having relinquished US citizenship on the earliest of four possible dates: (1) the date on which the individual renounces US nationality before a diplomatic or consular officer of the United States;⁴ (2) the date on which the individual furnishes to the State Department a signed statement of voluntary relinquishment of US nationality confirming the performance of an expatriating act;⁵ (3) the date on which the State Department issues a certificate of loss of nationality; or (4) the date on which a US court cancels a naturalised citizen’s certificate of naturalisation. The date on which the individual relinquishes citizenship is “the expatriation date.”

An individual is considered to terminate long-term US residency when the individual ceases to be a lawful permanent resident of the United States – that is, loses his or her green card status through revocation or administrative or judicial determination of abandonment of such status. An individual will also cease to be treated as a lawful permanent resident of the United States if he or she commences to be treated as a resident of a foreign country under a tax treaty between the United States and the foreign country, does not waive the benefits of the treaty applicable to residents of the foreign country, and notifies the Secretary of the commencement of such treatment. The date on which long-term residency is terminated is “the expatriation date.”

The current rule that provides that an individual continues to be taxed as a US citizen or long-term resident for US tax purposes until he or she files Form 8854, “Initial and Annual Expatriation Information Statement,” has been repealed.

The new regime does provide two exceptions to exclude citizens who would otherwise be considered “covered expatriates” because they satisfy either the net income tax liability requirement or the net worth requirement. The first exception applies to an individual who was born with citizenship both in the United States and in another country but only if: (1) as of the expatriation date, the individual continues to be a citizen of, and is taxed as a resident of, the other country, and (2) the individual has been a resident of the United States for not more than 10 taxable years during the 15-year period ending with the taxable year of expatriation. The second exception applies to a US citizen who relinquishes US citizenship before reaching age 18.5, but

only if the individual was a resident of the United States for not more than 10 taxable years before such relinquishment. This is much more lenient than the standards in the old regime for these two exceptions, which required that: (1) the individual not be present in the United States for more than 30 days in any calendar year that was one of the 10 calendar years preceding the expatriation date, and (2) for the dual-resident exception, the individual had never been a US resident.

II. The mark-to-market tax of section 877A(a)

Covered expatriates are now subject to the mark-to-market tax, an income tax on the net unrealised gain on their worldwide property as if the property had been sold for its fair market value on the day immediately prior to the expatriation date. Gain from the deemed sale is taken into account at that time without regard to other Code provisions. Any loss from the deemed sale generally is taken into account to the extent otherwise provided in the Code.

Any net gain on the deemed sale is recognised to the extent that it exceeds \$600,000 (which is increased by a cost-of-living adjustment factor for calendar years after 2008). This amount was coordinated with the estate tax exemption to help render an individual's decision to relinquish citizenship (or terminate residency) tax-neutral. Certain items – deferred compensation items, specified tax-deferred accounts, and interests in non-grantor trusts – are not subject to the mark-to-market tax, but rather are covered under other rules, as explained further below.

A covered expatriate may elect to defer payment of the mark-to-market tax imposed on the deemed sale, an option that is especially helpful to those who are not actually selling any assets and may not otherwise have the cash to pay the tax bill.⁶ The election to defer is irrevocable and is made on a property-by-property basis. If the election is made with respect to a particular property, the deferred tax attributable to such property is due when the return is due for the taxable year in which the property is eventually disposed of or, if the property is disposed of in a transaction in which gain is not recognised in whole or in part, at such other time as the Secretary may prescribe. In any event, the deferral period must end by the due date of the return for the taxable year in which the expatriated individual dies.

To elect deferral of the mark-to-market tax, the covered expatriate must furnish “adequate security” to the Secretary. Adequate security may be in the form of a bond or other security mechanism, such as a letter of credit, that adheres to the Secretary's (to be promulgated) requirements. In the event that the security provided with respect to a particular property subsequently fails to meet the requirements of these rules and the individual fails to correct such failure, the deferred tax and accrued interest with respect to such property will become immediately due. Realistically, for certain types of assets held by the expatriate, such as a limited partnership interest, it might be difficult to satisfy the security obligations.

As a further condition to making the deferral election, the covered expatriate must consent to the waiver of any treaty rights that would preclude the assessment or collection of the tax. Many of the current US income tax treaties may have to be renegotiated to prevent double taxation arising from the US's new exit tax on expatriates. When the old expatriation rules were

amended in 1996, the Congressional committee reports indicated that the Code overrode any conflicting treaty provisions for 10 years, but if any conflicting provision was still in force after 10 years, the treaty would override the amendments. When the expatriation rules were amended again in 2004, the committee reports were silent as to the interaction between the Code and treaties, leading to much confusion. Since the current committee reports are also silent on this subject, it is imperative that all US income tax treaties be reviewed and possibly amended to alleviate any double taxation burden.

The authors of the recent Fifth Protocol to the Canada-US income tax convention, signed on September 21, 2007, however, appear to have had this new regime in mind. The Protocol states that, with respect to an individual emigrating from one country to the other, for the purposes of taxation in the destination country, pre-departure gain taxed in the first country immediately before the individual's emigration will be exempt under the treaty from taxation in the destination country.⁷ As a result, there will be no tax payable in Canada on any pre-emigration gain (unless the property would otherwise be taxable, as is the case with certain immovable property located in Canada).

III. No real estate exception

This new exit tax regime was in the making for several years. Earlier versions of these rules had been commented on by various legal and accounting groups, which offered helpful advice to make the final legislation more effective and administrable. One noteworthy suggestion, which was not acted upon, was to add an exemption for US real property interests. Because such interests are currently subject to tax when owned by foreigners, it seems draconian to force expatriates to pay tax (or post security) on the appreciation on these assets upon expatriation when they would still be subject to tax upon actual disposition. Other countries, including Canada, exempt from their exit taxes assets that will otherwise be taxable upon their ultimate disposition.

Because the deemed sale occurs on the day immediately prior to the expiration date, the covered expatriate should still be eligible, however, for the partial exemption for gain on the sale of a personal residence. In addition, the deemed sale will increase the covered expatriate's basis such that any future actual disposition of the US real property will be taxable only to the extent of the increase in value from the date of the deemed sale to the date of the ultimate disposition of the property.

IV. Special rules for eligible deferred compensation items

As stated above, the mark-to-market tax does not apply to interests in "deferred compensation items." A deferred compensation item is: (1) any interest in certain enumerated plans,⁸ (2) any interest in a foreign pension or similar retirement arrangement or program, (3) any item of deferred compensation, or (4) any property, or right to property, that the individual is entitled to receive in connection with the performance of services to the extent not previously taken into account.

An “eligible deferred compensation item” is any deferred compensation item in which the payor is either a US person or a non-US person who elects to be treated as a US person for purposes of withholding, provided that the covered expatriate notifies the payor of his or her status as a covered expatriate and irrevocably waives any claim of withholding reduction under any treaty with the United States. There is no immediate tax upon expatriation with respect to “eligible deferred compensation items.” Rather, the payor must deduct and withhold from any “taxable payment” to the covered expatriate a tax equal to 30 percent of such taxable payment. Note that in order to be subject to this favourable deferral treatment, the expatriate must notify the payor of his or her status; otherwise the mark-to-market tax will apply. A taxable payment is subject to withholding to the extent that it would be included in the gross income of the covered expatriate if such person were subject to tax as a citizen or resident of the United States. A deferred compensation item is taken into account as a payment when such item would be includible in gross income. Employers have to watch out for these notices and make sure that they have appropriate withholding systems in place to comply with the new requirements.

If a deferred compensation item is not an “eligible” deferred compensation item, the deferred amount is deemed immediately includible in the expatriate’s income. The deferred amount is equal to the present value of the covered expatriate’s accrued benefit on the day before the expatriation date as a distribution under the plan, and it is subject to tax at US income tax rates. In the case of a deferred compensation item that is subject to section 83 of the Code, the rights of the covered expatriate to such item are treated as becoming transferable and no longer subject to a substantial risk of forfeiture on the day before the expatriation date. Justifiably, however, the Code does not subject these deemed distributions to the additional early distribution tax. Furthermore, appropriate adjustments are made to subsequent distributions to take into account the foregoing treatment.

These rules do not apply to a deferred compensation item to the extent that it is attributable to services performed outside the United States while the covered expatriate was not a citizen or resident of the United States.

V. Special rules for specified tax-deferred accounts

As stated above, the mark-to-market tax also does not apply to a “specified tax-deferred account,” which includes an individual retirement plan, a qualified tuition plan, a Coverdell education savings account, a health savings account, and an Archer medical savings account.⁹ If a covered expatriate holds an interest in any of these specified tax-deferred accounts on the day before the expatriation date, the covered expatriate is treated as having received his or her entire interest in such account as a distribution on the day before the expatriation date. But, again, these deemed distributions are not subject to the additional early distribution tax.

VI. Special rules for interests in trusts

The mark-to-market tax does not apply, finally, to any interest in a “non-grantor trust.” A “grantor trust” is a trust the income of which is taxable to the grantor for US tax purposes. For purposes of this section, the term “non-grantor trust” means the portion of any trust of which the covered expatriate is not considered to be the owner.

Special rules apply, however, if the covered expatriate was a beneficiary of a non-grantor trust on the day before the expatriation date. In the case of any direct or indirect distribution of property from a non-grantor trust to a covered expatriate for the remainder of the covered expatriate's lifetime, the trustee must deduct and withhold from the distribution an amount equal to 30 percent of the "taxable portion" of the distribution. The taxable portion with respect to any distribution is that portion that would be includible in the gross income of the covered expatriate if the covered expatriate continued to be subject to tax as a citizen or resident of the United States. The covered expatriate, for purposes of this rule, is treated as having waived any right to claim any reduction in withholding under any treaty with the United States, whether or not any such waiver is actually made. If the non-grantor trust distributes appreciated property to a covered expatriate, the trust must recognize gain as if the property were sold to the covered expatriate at its fair market value on the date of distribution.

These rules apply to both domestic and foreign non-grantor trusts. It will be interesting to see, when regulations are proposed, how the Secretary will seek to enforce these rules, especially against foreign trustees. Unlike the rule for deferred compensation, there is no duty imposed on the expatriate to notify the trustee of his or her status as a covered expatriate. In addition, this provision applies only to non-grantor trusts of which the covered expatriate was a beneficiary on the day before the expatriation date. Thus, if the trust was not created until after the expatriation date, or if the covered expatriate was not named as a beneficiary until after the expatriation date, future distributions from the trust would be free from US tax.

If a trust that is a non-grantor trust immediately before the expatriation date subsequently becomes a grantor trust of which a covered expatriate is treated, directly or indirectly, as the owner, such conversion is treated under the Code as a distribution to the covered expatriate to the extent of the portion of the trust of which the covered expatriate is treated as the owner.¹⁰ In the case of grantor trusts, the assets held by that portion of the trust of which the covered expatriate is considered to be the grantor are subject to the mark-to-market tax, and the amount required to be recognized at that time will not be taxable again upon its ultimate distribution from the trust. If a trust that is a grantor trust immediately before the expatriation date subsequently becomes a non-grantor trust, the trust remains a grantor trust for purposes of this Code provision.

VII. Miscellaneous provisions

A. Termination of deferrals

Any deferral of recognition of gain that the covered expatriate might have had is deemed to be terminated for purposes of calculating the mark-to-market tax. This provision includes incomplete transactions such as deferred like-kind exchanges and involuntary conversions. In addition, any extension of time for payment of tax ceases to apply on the day before the expatriation date, and the unpaid portion of such tax becomes due and payable at the time and in the manner prescribed by the Secretary.

B. Step-up in basis

For purposes of determining the tax imposed by the mark-to-market tax of section 877A, property that was held by a covered expatriate on the date on which he or she first became a resident of the United States is treated as having a basis of not less than the fair market value of the property on that date. A covered expatriate may make an irrevocable election to have this rule not apply.

VIII. Treatment of gifts and bequests from a covered expatriate

The HEART Act also added section 2801 to the Code, imposing a tax on certain “covered gifts or bequests” received by US citizens or residents. A covered gift or bequest is any property acquired directly or indirectly: (1) by gift from a person who is a covered expatriate¹¹ at the time of the acquisition, or (2) by reason of the death of an individual who was a covered expatriate immediately before death. The tax imposed by section 2801 is calculated as the product of: (1) the greater of the highest rate of tax applicable to estates and gifts, and (2) the value of the covered gift or bequest.

The tax imposed by section 2801 can conceivably arise even decades after the person expatriated, because there is no “statute of limitations” on gifts received from covered expatriates. It is difficult though to see how this will be enforced, especially when the transfer occurs many years after the person expatriated. The recipient might never know that he or she is liable for the tax. Also, it is difficult to see how the IRS will determine that a gift received from someone other than a covered expatriate indirectly came from a covered expatriate.

The tax on covered gifts and bequests is reduced by the amount of any gift or estate tax paid to a foreign country with respect to such covered gift or bequest. A covered gift or bequest, however, does not include any property: (1) shown as a taxable gift on a timely-filed gift tax return filed by the covered expatriate, or (2) included in the gross estate of the covered expatriate for estate tax purposes and shown on a timely-filed estate tax return filed by the estate of the covered expatriate. Additionally, a transfer to a covered expatriate’s spouse or to charity is excluded from the definition of a covered gift or bequest. Section 2801 does not, however, address whether recipients of covered bequests may elect alternate or special-use valuation.

The tax is imposed upon the recipient of the covered gift or bequest and is imposed on a calendar-year basis. For covered gifts, the tax is imposed only to the extent that the total value of covered gifts received by the recipient during the calendar year exceeds the amount of the annual per-donee exclusion under section 2503(b).¹² For US taxpayers, the annual per-donee exclusion amount applies to gifts, “other than gifts of future interests in property.” The definition of a covered gift (or bequest), however, refers only to “property.” This leaves open the interpretation that the annual per-donee exclusion provided under section 2801(c) applies to both a gift of a present interest in property and a gift of a future interest in property, as section 2801(c) expressly incorporates by reference only the annual per-donee amount of section 2503(b). It seems unlikely, though, that Congress would extend the annual-per-donee exclusion to gifts of future interests in property made by covered expatriates when it disallowed it to such gifts by other US taxpayers.

Special rules are also included to impose taxation upon covered gifts or bequests made to domestic or foreign trusts. In the case of a covered gift or bequest made to a domestic trust, the tax applies as if the domestic trust were a US citizen, and the trust is required to pay the tax.

For purposes of these rules, a foreign trust may elect to be treated as a domestic trust; such election may be revoked only with the Secretary's consent. In the case of a covered gift or bequest made to a foreign trust (that did not elect to be treated as a domestic trust), the tax applies to any distribution from the trust (whether from income or from corpus), attributable to the covered gift or bequest, to a recipient who is a US citizen or resident in the same manner as if such distribution were a covered gift or bequest. Unfortunately, there is no guidance as to how to determine what portion of the distribution is attributable to the covered gift or bequest, rather than to other property owned by the trust, rendering the enforcement of this provision even more difficult.

A US citizen or resident that is a recipient of a distribution from a foreign trust may deduct the amount of the tax imposed by section 2801 for income tax purposes to the extent that the tax is imposed upon the portion of the distribution that is included in the recipient's gross income. This deduction takes into account the fact that the fiduciary income tax rules of the Code already tax the receipt of income by a US person from a foreign trust, and it thus seeks to prevent the double taxation of such income.

IX. Effective date

The new exit tax regime is effective for US citizens who relinquish citizenship or long-term residents who terminate their residency on or after the date of enactment, June 17, 2008. The portion of the provision relating to covered gifts and bequests is effective for gifts and bequests received on or after June 17, 2008 from former citizens or former long-term residents (or the estates of such persons) whose expatriation date is on or after June 17, 2008.

X. Coming back

If a covered expatriate becomes subject to tax as a citizen or resident of the United States for any period beginning after his or her expatriation date, the individual is not treated as a covered expatriate during that period for purposes of applying the withholding rules relating to deferred compensation items, the rules relating to interests in non-grantor trusts, and the rules relating to gifts and bequests from covered expatriates. If the individual again relinquishes citizenship or terminates long-term residency (after meeting anew the requirements to become a long-term resident), the mark-to-market tax and other provisions are again triggered upon the new expatriation date.

XI. Who benefits from the new regime?

For some people contemplating expatriation, this new regime is a welcome relief. For individuals who hold most of their assets in cash and unappreciated property, and who have no heirs who will be US residents or citizens in the future, the new regime permits expatriation with little immediate tax and no worries about future gifts and bequests. Those individuals will be

able to come to the United States as needed without having to manoeuvre around the former 30-day annual limitation. Nor need they worry that they must survive another 10 years from the expatriation date in order to avoid US estate taxes. They can continue to purchase US securities, and future appreciation in such securities will be free from US taxation.

For individuals with most of their assets in appreciated property, however, the cost is significantly higher, and further investigation is needed before expatriation. For those who expect their family to expatriate as well (or for those whose families are not already US citizens and/or residents), it might make sense to expatriate now, pay the current capital gains tax rate, and start the next chapter of their lives, especially while the capital gains tax rate is relatively low. For those with children who will continue to be US residents and/or citizens, careful analysis is required to see if the eventual tax imposed on gifts and bequests outweighs the benefits of expatriation.

XII. Conclusion

Given the current political environment, the fact that an individual could trigger all of his or her capital gains this year (while rates are low and values even lower), without worrying about surviving the next 10 years, might be all that was needed for some people, who had been contemplating the idea of expatriating, to act this year. It is very possible that capital gains rates will increase drastically in the future, as could estate taxes. Many people have already cashed out their investments this year owing to poor market conditions (and thus have already effectively marked themselves to market), and they therefore would have to pay little, if any, additional tax upon expatriation. There is also an incentive for those people who have not yet accumulated much wealth to expatriate now. Given the global economy and the ability to work from virtually anywhere these days, there is little impediment to relocating to a low-tax jurisdiction and making one's fortune there.

The decision to maintain US citizenship or residency, however, involves much more than taxation. The decision also includes, for example, political ideologies, proximity to family and friends, and employment opportunities. One should not let taxation alone rule this decision.

¹ See the Internal Revenue Code of 1986, as amended (herein referred to as “the Code”), section 7701(b)(1)(A)(ii). Unless otherwise stated, statutory references in this article are to the Code.

² Rev. Proc. 2007-66, section 3.29, 2007-45 IRB 970. This amount is indexed each year to reflect cost-of-living increases.

³ All references to “the Secretary” are to the Secretary of the Treasury, unless otherwise indicated.

⁴ Provided that the voluntary relinquishment is later confirmed by the issuance of a certificate of loss of nationality. Section 877A(g)(4).

⁵ *Id.*

⁶ Section 877A(b)(1). Interest is charged for the period the tax is deferred at the rate normally applicable to individual underpayments. Section 877A(b)(7).

⁷ See Article 8 of the Protocol Amending the Convention Between Canada and the United States of America with Respect to Taxes on Income and on Capital, done at Washington, DC, on September 26, 1980, as amended by the Protocols done on June 14, 1983, March 28, 1984, March 17, 1995, and July 29, 1997, signed at Chelsea, Quebec, on September 21, 2007.

⁸ The enumerated plans and arrangements are those described in section 219(g)(5), which include certain exempt trusts; certain annuity plans; plans established by, and for employees of, the United States, by a State or political

subdivision thereof, or by an agency or instrumentality of any of the foregoing; annuity contracts; simplified employee pensions; simplified retirement accounts; and certain other trusts.

⁹ Section 877A(e)(2). Simplified employee pensions (within the meaning of section 408(k)) and simplified retirement accounts (within the meaning of section 408(p)) of a covered expatriate, however, are treated as deferred compensation items and not as specified tax-deferred accounts.

¹⁰ See United States, Staff of the Joint Committee on Taxation, *Technical Explanation of H.R. 6081, the "Heroes Earnings Assistance and Relief Tax Act of 2008," as Scheduled for Consideration by the House of Representatives on May 20, 2008*, JCX-44-08 (Washington, DC: Joint Committee on Taxation, May 20, 2008), p. 44.

¹¹ For purposes of section 2801, "covered expatriate" has the meaning given to such term by section 877A(g)(1).

¹² Sections 2801(a)-(c). The annual per-donee exclusion amount is \$12,000 for 2008. See Rev. Proc. 2007-66, *supra* note 3, section 3.32(1).