

The Tax Rules Just Changed: Emotions Aside, Does Expatriating Make Financial Sense?

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The new rules target individuals with a high net worth or a history of high income tax liability. Not only is there a new exit tax, but U.S. recipients of gifts or bequests from such "covered expatriates" will be potentially subject to transfer taxes. There are important exceptions, and those who expatriated before the change in the law will continue to be subject to the old rules.

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Because the U.S. subjects its residents to income tax on their worldwide income, and subjects those who are domiciled in the U.S. to estate tax on their worldwide assets, many individuals actively look for ways to reduce or eliminate their U.S. tax obligations. Offshore tax havens are plentiful, and—provided the accounts or activities taking place in those jurisdictions are properly reported to the IRS—they are legal. Some taxpayers, however, wish to cease paying U.S. tax altogether. Expatriation is one approach available to taxpayers who wish to legally eliminate their U.S. tax obligations. The consequences of pursuing this course of action, particularly in light of the Heroes Earnings Assistance and Relief Tax Act of 2008 (P.L. 110-245, 6/17/08; the "HEART legislation"), are explored below.

Expatriation generally is the voluntary departure from the nation of one's birth for permanent or prolonged residence in another nation.¹ For purposes of U.S. taxation, however, the concept of expatriation is much broader. Whether a U.S. citizen or a long-term U.S. resident (i.e., green card holder), the same tax rules apply should the taxpayer desire to abandon any and all rights afforded under U.S. law. While there is a formal process that must be followed in order to successfully expatriate (hereafter, such persons will be referred to as "expats"), the enactment of the HEART legislation has changed the tax consequences of the process significantly.

The HEART legislation provides significant benefits to veterans.² To offset the approximate \$1.2 billion price tag of those benefits, the HEART legislation repealed Section 877 for any taxpayer expatriating after 6/16/08. In its place, Congress created new Sections 877A and 2801, to which all expats will now be subject. The new legislation is expected to raise \$600 million by subjecting all new expats to a mark-to-market exit tax. Additionally, new Section 2801 subjects U.S. recipients of gifts and bequests from expats to gift or estate tax.

Notwithstanding the creation of Section 877A, Section 877 remains in effect for all expats who expatriated prior to 6/17/08. Consequently, expats who expatriated prior to the date of enactment of the HEART legislation remain subject to an alternative U.S. income tax regime for ten years

following the date of expatriation (the "subsequent ten years"). The rules applicable to these expats also differ for estate and gift tax purposes during the subsequent ten years.

The manner in which the new Section 877A expatriation rules apply, as well as exceptions to those rules, differs based on the identity of the expat, i.e., whether the expat is a current U.S. citizen or green card holder.

WHO IS SUBJECT TO THE RULES

The HEART legislation applies to a "covered expatriate," which by its very definition in Section 877A(g)(1) includes certain U.S. citizens and green card holders.

Citizens

While the expatriation rules apply equally to U.S. citizens and green card holders, only certain such individuals will actually be affected. This is because a "covered expatriate" only includes those U.S. citizens seeking to expatriate who have (1) a net worth of at least \$2 million on the date of expatriation or (2) an average annual net income tax for the five tax years prior to expatriation greater than \$139,000 (this amount adjusts periodically for inflation).

Notwithstanding the foregoing, even if the U.S. citizen does not have the specified net worth or income tax liability, if the U.S. citizen fails to certify under penalties of perjury that he or she has been compliant with U.S. tax laws for the five-year period prior to expatriation, the U.S. citizen also will be a covered expatriate and subject to the rules. Therefore, even if the U.S. citizen seeking to expatriate does not have significant wealth that meets or exceeds the net worth or income tax thresholds, the expatriation rules still will apply absent a certification under penalties of perjury.

Green Card Holders

As stated above, the expatriation rules also apply to those persons in possession of a green card. Nevertheless, a green card holder will be subject to the expatriation rules, and thus will be a covered expatriate, only if he or she has been a permanent U.S. resident for at least eight of the 15 years prior to expatriating including the year of expatriation.³

Even with a green card, however, if the individual can be classified as a resident of a foreign country for any year during the 15-year period through a treaty tie-breaking provision, then such individual would be deemed not to be a U.S. resident for such year. Consequently, it is possible that the expatriation rules may not apply to a green card holder who has a residence or domicile in a country with which the U.S. has an income tax treaty. Furthermore, if an individual were to expatriate prior to residing in the U.S. for eight years, the expatriation rules would not apply unless such individual were to return to the U.S. within the remaining 15-year period.

Resident Aliens (Non Green Card Holders)

Prior to the HEART legislation, certain individuals who qualified as U.S. resident aliens under the substantial-presence test of Section 7701, regardless of whether such aliens possessed a green card, also were subject to the alternate tax system to which expats were subject. The tax applied to all individuals who:

- (1) Were U.S. residents for three consecutive years,
- (2) During such three-year period were physically present in the U.S. for at least 183 days each year,
- (3) Became nonresident aliens following the third consecutive year in which they were U.S. aliens, even if such nonresident status was obtained through an income tax treaty tie-breaker provision, and
- (4) Became U.S. residents within the three-year period following the year such aliens ceased to be so classified.⁴

Consequently, U.S. residents under the substantial-presence test no longer have to worry about falling subject to the expatriation rules. If, however, a covered expatriate should happen to become a U.S. citizen or green card holder in any year subsequent to such covered expatriate's expatriation, the individual will not be treated as a covered expatriate in those years for purposes of the HEART legislation tax provisions, and instead will be taxed as a U.S. resident.⁵

In addition, if a covered expatriate who subsequently becomes a U.S. citizen or green card holder should once again expatriate, the mark-to-market exit tax will once again be applicable.⁶

EXCEPTIONS

The HEART legislation expanded the breadth of the exceptions for the two types of U.S. citizens who, if they expatriate, are exempt from the expatriation rules.

Dual citizenship. The first exception applies to individuals who became dual citizens at birth. In order to qualify for exemption, (1) the individual must have obtained U.S. citizenship solely by reason of birth as well as citizenship of another country, (2) at the time of the expatriation the individual must remain both a citizen and income tax resident of the other country, and (3) the individual must not have qualified as a U.S. resident under the substantial-presence test for more than ten years out of the 15-year period ending with expatriation.⁷

The pre-HEART legislation rules exempted dual citizens who did not have substantial contact with the U.S.⁸ A child with dual citizenship was deemed to have had substantial contact with the U.S. if such child (1) ever qualified as a U.S. resident under the substantial-presence test, (2) had a U.S. passport, or (3) was physically present in the U.S. for more than 30 days in any of the ten years before expatriating.⁹

Children. The second exception applies to children who expatriate (1) before attaining the age of 18½ and (2) who did not qualify as a U.S. resident under the substantial-presence test for more than ten years out of the 15-year period ending with expatriation.¹⁰ The prior rules denied the exemption to a dual citizen child if (1) either of the child's parents was a U.S. citizen or (2)

the child was in the U.S. for more than 30 days in any of the ten years preceding the expatriation.¹¹

There is no similar exception for children who were long-term residents. Consequently, if a child who has a green card was in the U.S. at least eight out of the 15 years prior to expatriating and failed any of the requirements (i.e., income tax, net worth, or certification), such child would be subject to the expatriation rules of Section 877A, and the mark-to-market exit tax.

PROPERLY EXPATRIATING

Simply leaving the U.S., even with the stated intent of never returning, is not sufficient. A process must be followed in order to properly expatriate, which differs based on whether the expat is a citizen or long-term resident. The expat is required to terminate his or her U.S. status for immigration purposes.

In contrast, the prior rules not only required this first step but also required the expat to terminate his or her U.S. status for income tax purposes. Failure to follow both steps led to a perverse situation where an expat would remain subject to U.S. tax even though the expat no longer had the right under the immigration laws to be in the U.S.

The "expatriation date" is the date on which an individual relinquishes his or her citizenship or, for a long-term resident, the date on when the resident ceases to be classified as such.¹²

Renouncing U.S. Citizenship for Immigration Purposes

A U.S. citizen's expatriation date will be the earliest of the following four dates:

- (1) When the individual renounces U.S. nationality before a diplomatic or consular officer of the U.S. pursuant to paragraph (5) of section 349(a) of the Immigration and Nationality Act.
- (2) When the individual furnishes the State Department with a signed statement of voluntary relinquishment of U.S. nationality conforming with paragraph (1), (2), (3), or (4) or section 349(a) of the Immigration and Nationality Act.
- (3) When the State Department issues a certificate of loss of nationality.
- (4) When a U.S. court cancels a citizen's certificate of naturalization.¹³

Steps 1 and 2 must be confirmed by the State Department's issuance of a certificate of loss of nationality.¹⁴ Until the State Department approves the expatriation, the expat will remain a U.S. citizen and will be subject to U.S. tax on worldwide income. At such time as the expatriation is accepted, however, the expatriation date will be retroactive to the date when the individual renounced such citizenship in front of the diplomatic or consular officer.

Renouncing U.S. Residency for Immigration Purposes

A permanent long-term resident's expatriation date will be the date on which the individual loses his or her green card status through revocation or on which it has been administratively or

judicially determined to have been abandoned. ¹⁵ Filing Form I-407, "Abandonment of Lawful Permanent Resident Status," ¹⁶ is equivalent to surrendering the green card and having it administratively terminated. In the event the permanent long-term resident never loses his or her green card, such individual will cease to be treated as a lawful permanent resident if the individual:

- (1) Begins to be taxed as a resident of a foreign country under a tax treaty between the U.S. and the foreign country,
- (2) Does not waive the benefits of the treaty applicable to residents of the foreign country, and
- (3) Notifies the IRS of the commencement of foreign residency under the treaty. ¹⁷

Prior Law—Renouncing U.S. Status for Tax Purposes

Individuals who expatriated prior to the HEART legislation had to file Form 8854 to notify the IRS of the expatriation. ¹⁸ While there was no due date for the filing of the initial Form 8854, such an expat remained subject to U.S. income tax on the expat's worldwide income until such form was filed. ¹⁹ Consequently, it was possible for an individual to become an expatriate for U.S. immigration purposes before such person became an expatriate for U.S. tax purposes.

While Form 8854 had to be filed to indicate that an expat had expatriated or terminated the expat's green card status, it also had to be filed in each of the subsequent ten years. The annual forms—which required detailed income, asset, and liability information—were due on the date the person's U.S. tax return would have been due. For individuals who expatriated prior to the HEART legislation, this requirement continues throughout the ten-year period following expatriation. ²⁰ As a general rule, the expat also should have filed Form 1040-C, the Departing Alien Income Tax Return, commonly known as the "sailing permit," which was used to confirm the absence of U.S. income tax liability.

Persons who expatriate after the HEART legislation are also required to file Form 8854 reflecting their expatriation, but there is no requirement to file it for the next ten years. ²¹ Any expats who fail to file Form 8854 or file an incomplete form are subject to a \$10,000 penalty. ²² There is, however, a reasonable cause defense under which the government may waive the penalty. There does not appear to be any requirement to file Form 1040-C.

U.S. Presence Following Expatriation

The new law eliminates the prohibition on subsequent visits to the U.S. by covered expatriates. This is in contrast to the old law that remains in place for expats who expatriated within the past ten years, and for whom the old rules remain in place. Consequently, expats who expatriated prior to 6/17/08 and who (1) return to the U.S. within the subsequent ten years and (2) remain in the U.S. for more than 30 days will once again be subject to U.S. tax on their worldwide income. ²³

Essentially, under the old rules the expatriation will be ignored and classification as a U.S. resident will be on a year-to-year basis. Consequently, if the expat leaves the U.S. the year

following such a return to the U.S., the expat will once again be subject to the alternate tax system, and the original ten-year period. That is, the ten-year period does not begin anew. The 30-day rule is relatively straight-forward, any day of U.S. presence is counted, and the exceptions that generally are available to nonresident aliens for counting days of presence under Section 7701 are not available.²⁴

If the expat is in the U.S. for more than 30 days but spends that time exclusively working for an employer who is not related to the expat, then up to 30 additional days of presence will be exempt.²⁵ Thus, eligible expats may effectively spend up to 60 days in the U.S. provided that the 30 additional days are spent actually performing services in furtherance of their employment.

Days not working—weekends or holidays—are counted as days of U.S. presence. If there are more than 30 of these days, the expat will be subject to U.S. income tax on his or her worldwide income. Additionally, the expat must not have been physically present in the U.S. for more than 30 days in any one of the ten years prior to the date of expatriation, or the expat must be a citizen or resident of a country in which he, his spouse, or either of his parents was born and be fully subject to income tax in that country.²⁶

The U.S. Attorney General has the right to deny re-entrance to the U.S. to any expat. This rule is known as the Reed Amendment, and while it has yet to be used as grounds to deny readmission, it is a significant threat. While the Reed Amendment is generally applicable to anyone who expatriated for purposes of avoiding federal tax, there is no system in place for the IRS or the government to make such decisions, and perhaps this is the reason that the Attorney General has yet to use such authority. Notwithstanding, if an expat fails to file Forms 8854 or pay the required tax under the alternative tax system for the subsequent ten years, it would appear that the Attorney General would have sufficient grounds to deny such expat readmission to the U.S.²⁷

TAX IMPLICATIONS

The focal point of the HEART legislation is the mark-to-market exit tax, which subjects covered expatriates to tax on the net unrealized gain in their property. The property is deemed sold on the day before the expatriation date and, the extent to which the gain exceeds \$600,000, the covered expatriate will pay a tax.²⁸

If the covered expatriate is deemed to be the owner of a trust under the grantor trust rules, then all of the assets held by the trust that are deemed owned by the covered expatriate will be subject to the mark-to-market tax.²⁹ Covered expatriates are deemed to have received a distribution of their entire interest in an IRA and other tax-deferred accounts³⁰ on the day before their expatriation date³¹ (no early distribution penalty tax would apply³²), and appropriate adjustments would be made to subsequent distributions from the account to reflect such treatment.³³

For purposes of determining the gain, no other Code provisions are applicable,³⁴ and the time periods provided by any Code provisions that permit a taxpayer to reduce the amount of gain recognized by acquiring property terminate on the date before the covered expatriate's expatriation date.³⁵ Additionally, any time periods that provide taxpayers with an extension to

pay tax cease to apply, and the tax will be due and payable at the time and manner as prescribed by the IRS.³⁶

The rules for determining loss contrast with those for determining gain as loss is determined in accordance with other Code provisions, except for the wash sale rules of Section 1091, which do not apply.³⁷ Subsequent gains and losses that are recognized will be adjusted for the gains and losses recognized under the deemed sale rules, without regard to the \$600,000 exemption.³⁸

The basis of the property owned by a covered expatriate who was a green card holder prior to expatriation is stepped-up so that the basis is no lower than the FMV of the property on the date the covered expatriate first became a U.S. resident.³⁹ The covered expatriate may make an irrevocable election to avoid the application of this basis step-up rule.⁴⁰

If the act of expatriating would generate a tax under Section 684, the exit tax is applied after the application of Section 684.⁴¹ Generally, Section 684 requires a U.S. person to recognize tax when appreciated property is transferred to either a foreign trust or a foreign estate.⁴² The transfer is treated as a sale or exchange in an amount equal to the FMV of the property transferred. These rules also will apply when a U.S. person transfers appreciated property to a nonresident alien, but there is an exception for transfers that use the U.S. person's gift tax exemption.⁴³

Deferral election. A covered expatriate may defer payment of the exit tax "until the due date of the return for the taxable year in which such property is disposed of (or, in the case of property disposed in a transaction in which gain is not recognized in whole or in part, until such other date as the Secretary may prescribe)."⁴⁴ Interest is charged during the deferral period at the rate applicable to underpayments.⁴⁵ The deferral cannot extend beyond the due date on which an estate tax return would be due for the covered expatriate, or earlier if the security no longer meets the Service's requirements.⁴⁶

The election to defer tax can be made on a property-by-property basis, and is irrevocable once made.⁴⁷ In order to elect deferral, however, the covered expatriate must provide the IRS with adequate security⁴⁸ and waive any treaty rights that would preclude assessment or collection of tax.⁴⁹ Adequate security includes a bond accepted by the IRS, which is conditioned on the payment of tax and interest, and meets the requirements of Section 6325.⁵⁰ Additional forms of security may be accepted, such as a letter of credit, provided they meet requirements set by the IRS.⁵¹

Exceptions. While most property owned by a covered expatriate is subject to the mark-to-market exit tax, there are two types of property that are excluded.⁵² These include certain interests in deferred compensation plans⁵³ and nongrantor trusts.⁵⁴ Instead of the exit tax, a withholding obligation is imposed on third parties who deal with a covered expatriate. This withholding replaces any withholding that otherwise would have been required under the Code.⁵⁵ The third parties, as discussed below, must be U.S. persons, and are required to withhold 30% of any distribution to a covered expatriate.⁵⁶

Deferred compensation. For purposes of distributions from a deferred compensation plan, this withholding obligation only exists if the covered expatriate has an "eligible deferred compensation item."⁵⁷ Such an item requires:

- (1) A payor who is a U.S. person or elects to be treated as a U.S. person for purposes of the withholding obligation.
- (2) A covered expatriate who notifies the payor of his or her status.
- (3) An irrevocable waiver by the covered expatriate of any rights to treaty benefits that could reduce the tax.⁵⁸

In addition, the deferred compensation plan must be based on services the covered expatriate provided inside the U.S.⁵⁹

The withheld distribution to a covered expatriate from an eligible deferred compensation plan is subject to tax under Section 871 provided such payment would have been included in the covered expatriate's gross income had he or she remained a U.S. citizen or green card holder.⁶⁰ This contrasts with the tax treatment of an interest in an ineligible deferred compensation plan:

- If the item is not subject to tax under Section 83, then "an amount equal to the present value of the covered expatriate's accrued benefit shall be treated as having been received" by the covered expatriate on the day before the expatriation date, and is subject to the exit tax.⁶¹
- If the item is subject to tax under Section 83, then the item is treated as no longer subject to a substantial risk of forfeiture on the day before the expatriation date.⁶² Appropriate adjustments need to be made to subsequent distributions from the plan to reflect that the risk no longer exists,⁶³ and the early distribution tax will not apply to these deemed distributions.⁶⁴

Nongrantor trusts. When a nongrantor trust makes a distribution, whether direct or indirect, to a covered expatriate, the trustee is required to withhold 30% of the "taxable portion" of the distribution.⁶⁵ Questions arise as to how the IRS can enforce this requirement when there is a foreign trustee of a foreign trust, and there is no U.S. nexus.

The taxable portion of the distribution is the amount subject to tax under Section 871 if such payment would have been included in the covered expatriate's gross income had he or she remained a U.S. citizen or green card holder.⁶⁶ This withholding obligation arises only if the covered expatriate was a beneficiary of the nongrantor trust on the day before the expatriation date.⁶⁷

The covered expatriate is deemed to have made an irrevocable waiver of any rights to treaty benefits, which otherwise could reduce the tax. This approach is contrary to the requirement in the deferred compensation context, where the covered expatriate must affirmatively waive such benefits.⁶⁸

If the nongrantor trust distributes appreciated property to the covered expatriate, the trust must recognize gain as if the property was sold to the covered expatriate at its then FMV.⁶⁹ If a

covered expatriate is deemed to become the owner of a nongrantor trust subsequent to expatriating, this will be viewed as a conversion and treated under Section 877A(f)(1) as a distribution to the covered expatriate in an amount equal to the value of the property he or she is deemed to own under the grantor trust rules.⁷⁰

Income Tax Rules Under Prior Law

Nonresident aliens are subject to U.S. income tax at graduated rates for income effectively connected to a U.S. trade or business, and to a 30% or lower treaty rate on U.S. source passive income.⁷¹ Capital gains earned by a nonresident alien, except for those attributable to the sale of U.S. real property, generally are not subject to U.S. income tax. Expats who expatriated prior to the HEART legislation are subject to tax during the subsequent ten years in a manner similar to a nonresident alien, unless the tax liability under an alternative tax system is greater.⁷²

The alternative system is essentially the same as that under which a nonresident alien is taxed, except for an expanded definition of U.S. source income. Under the alternative system, U.S. source income includes the following:

- (1) Capital gains on the sale of U.S. stock or debt obligations.
- (2) Income earned from a controlled foreign corporation.
- (3) Gain that would have been earned on the sale of a U.S. asset that was transferred to a foreign jurisdiction within the five years prior to expatriation.
- (4) Gain on what otherwise would have been a tax-free exchange of property.
- (5) Gain on the sale of a principal home in the U.S.

Expats are denied capital loss carryover and are entitled to take deductions only on expenses that were directly connected with the gross income earned.

Transfer Taxes

The HEART legislation also enacted new Section 2801, which applies to "covered gifts" and "covered bequests" from covered expatriates who expatriated after 6/16/08.⁷³ For this purpose:

- A covered gift is any property acquired by gift directly or indirectly from an individual who is a covered expatriate at the time the gift is received.⁷⁴
- A covered bequest is any property acquired directly or indirectly by reason of death from an individual who was a covered expatriate immediately before death.⁷⁵

The new legislation taxes the U.S. *recipient* of a gift or bequest from a covered expatriate.⁷⁶ The tax is the product of the highest estate or gift tax rate in effect at the time of receipt and the value of the gift or bequest.⁷⁷ The legislation does not exempt property obtained by a covered expatriate subsequent to the expatriation date even if it is foreign situs property. Thus, the gift or bequest of *any* asset from a covered expatriate to a U.S. person subjects the U.S. recipient to tax.

Exceptions. If a charitable deduction or marital deduction would have been available had the donor or decedent been a U.S. person, then the gift or bequest will not be classified as a covered

gift or bequest.⁷⁸ Similarly, if the donor or decedent reflects the gift or bequest on a timely filed U.S. gift tax return or estate tax return, and tax is paid, then the U.S. recipient of the gift or bequest will not have to pay tax on the receipt of property.⁷⁹

The tax imposed on the U.S. recipient will be reduced by any foreign gift or estate tax paid by the donor or decedent.⁸⁰ Finally, only covered gifts or covered bequests in excess of the then-applicable annual exclusion will be subject to tax.⁸¹

Transfers in trust. When a covered gift or covered bequest is made to a *domestic* trust, the trust will be a U.S. person and, as such, will be required to pay the corresponding gift or estate tax.⁸²

If the covered gift or covered bequest is made to a *foreign* trust that has any U.S. beneficiaries, gift or estate tax will be due when a distribution is made to such a beneficiary.⁸³ The U.S. beneficiary is able to deduct the tax for income tax purposes to the extent tax is imposed on the distribution that is included in the U.S. beneficiary's gross income.

The trustee of a foreign trust can elect to have a foreign trust treated as a domestic trust solely for purposes of Section 2801, which could assist the U.S. beneficiaries with tax reporting.⁸⁴ Once such an election is made, however, it cannot be changed without the Service's consent.⁸⁵

Estate Tax Rules

The estate tax rules applicable to expats and covered expatriates are similar to those that apply to non-citizen/non-resident decedents (NCNRs).⁸⁶ NCNRs are subject to U.S. estate tax on their U.S.-situs assets,⁸⁷ and are provided an exemption from U.S. estate tax on the first \$60,000 of their U.S.-situs assets.⁸⁸ Expats and covered expatriates are similarly subject to U.S. estate tax on U.S.-situs property and provided an exemption on the first \$60,000 of U.S.-situs assets.⁸⁹ Expats, covered expatriates, and NCNRs also may benefit from the marital deduction and the charitable deduction.

Generally, a transfer of non-U.S.-situs property from an NCNR made directly to a U.S. person or to a trust for U.S. persons will avoid generation-skipping transfer (GST) tax.⁹⁰ The GST tax is imposed on a transfer of property from an NCNR only if the transfer is subject to federal gift or estate tax. As a result of the HEART legislation imposing gift and estate tax on the U.S. recipients of covered gifts and covered bequests, it would appear that covered expatriates—unlike expats and NCNRs—will no longer be able to make GST-exempt transfers.

An NCNR who dies owning the stock of a foreign corporation is exempt from U.S. estate tax because the stock does not have a U.S. situs.⁹¹ For expats who expatriated under prior law and who die within the subsequent ten years, however, the stock of a foreign corporation owned directly or indirectly by such an expat could be treated as U.S.-situs property.⁹² If the foreign corporation held U.S.-situs assets, a portion of the stock of such corporation would be treated as U.S.-situs property so long as the deceased expat owned, directly or indirectly, either:

- (1) 10% or more of the voting power of all classes of stock.

(2) More than 50% of the total voting stock or more than 50% of the total value of the foreign corporation.⁹³

This rule prevents an expat from transferring ownership of U.S.-situs assets to a controlled foreign corporation prior to expatriation in order to avoid U.S. estate tax.

Green card holders who were able to qualify as residents of a country with which the U.S. has an income tax treaty such that they did not qualify as U.S. residents for income tax purposes and who maintained a domicile in the treaty country were not subject to U.S. estate tax on U.S.-situs assets owned through a controlled foreign corporation.

PLANNING

Anyone considering expatriating should plan carefully, as the expatriation rules apply only to those persons who meet either (1) the net worth test, (2) the income tax liability test, or (3) the certification tests of Section 877(a)(2). Making use of an individual's \$1 million lifetime gift exemption is an easy way to reduce the individual's net worth.

If a U.S. person is a beneficiary of a foreign trust, another option is for the individual to ask the trustee to permanently remove him or her as a beneficiary of the trust. While this can also be done with a U.S. trust, the removal provisions are more common with a foreign trust. Depending on how often the trustee made distributions, the size of those distributions, and whether the throwback rules apply, removing the individual as a beneficiary far enough in advance of expatriation could reduce the individual's tax liability.

Alternatively, if the individual's wealth is tied up in a foreign trust of which the individual is a beneficiary and not a grantor, another option for those who are more aggressive is to play the audit game, and see how the IRS can enforce the 30% withholding obligation on the foreign trustee.

Green card holders are exempt from the expatriation rules provided they have been in the U.S. for less than eight out of the 15 years before expatriating. Any holder of a green card who is not committed to becoming a U.S. resident, and wants to avoid being subject to either U.S. estate tax at death or the exit tax on leaving the U.S., should consider relinquishing the green card before reaching the eighth year.

Dual citizens also are exempt from the expatriation rules provided they meet certain minimal requirements (attained both U.S. citizenship and citizenship in a foreign country at birth; remain a citizen and income tax resident of the foreign country; have not been in the U.S. under the substantial-presence test for more than ten years during the 15-year period prior to expatriating). Because the dual citizen exemption is tied to residency under the substantial-presence test, it is somewhat easier to plan around. If a dual citizen has been physically present in the U.S. for more than ten out of the last 15 years, and would like to expatriate, such dual citizen will need to wait to expatriate, and should be certain to refrain from qualifying as a resident under the substantial-presence test as needed so the ten out of 15 year requirement can be satisfied. Of course, this will

only work if the dual citizen becomes a taxpaying resident of the foreign country in which he or she also has citizenship.

CONCLUSION

The existing process for expatriation is complex and the HEART legislation makes the process and the consequences of expatriation potentially more expensive. Before giving serious consideration to expatriation, a U.S. person would be well advised to consult with legal, financial, and accounting professionals who are well versed in this area.

If an individual who expatriates has U.S. family members, and such members either receive (1) outright gifts, (2) distributions from a trust, or (3) bequests from the covered expatriate, the U.S. family members will have increased compliance obligations. Not only may a Form 3520 be required to report the receipt of foreign gifts or bequests from a foreign person or foreign estate, or distributions from a foreign trust, but the U.S. persons also may have to pay gift or estate tax on the receipt of the distribution or bequest.

An often overlooked requirement is the TD F 90-22.1,⁹⁴ which also may have to be filed to report an interest in a foreign account. Finally, it is imperative for anyone who may have already expatriated prior to the HEART legislation to continue to keep track of and respect the obligations of the subsequent ten years.

Practice Notes

Advance planning is key for anyone seeking to expatriate after 6/16/08. The exit tax on covered expatriates and the gift and estate tax imposed on U.S. recipients of a gift or bequest from a covered expatriate might be avoidable if the potential expatriate can fail the net worth or income tax liability tests.

[1](#)

New Section 877A(g)(2), added by the HEART legislation, defines an expatriate as "any United States citizen who relinquishes his citizenship, and ... any long-term resident of the United States who ceases to be a lawful permanent resident of the United States...."

[2](#)

These include (1) flexibility for veterans who finance their home purchases, (2) inclusion of combat pay as income for purposes of the earned income tax credit, and (3) eliminating penalties on withdrawals from retirement plans. A detailed discussion of the benefits provided to veterans is beyond the scope of this article.

[3](#)

Even if an individual is present in the U.S. for one day, so long as the individual has a green card, the one day will classify as one year of U.S. residency; see Section 7701(b)(1)(A)(i). Consequently, if an individual arrived in the U.S. with a green card on 12/31/02 and continued

living in the U.S. through 1/1/09, the expatriation rules would apply. The one day of presence in 2002 and 2009 would count as full years, as would the full years 2003-2008.

[4](#)

Reg. 301.7701(b)-5.

[5](#)

Section 877A(g)(1)(C). For these purposes, Sections 877A(d)(1), 877A(f), and 2801 will not apply in any such years that a covered expatriate once again is classified as a U.S. citizen or green card holder.

[6](#)

Section 877A(g)(1)(C).

[7](#)

Section 877A(g)(1)(B)(i).

[8](#)

Section 877(c)(2)(A).

[9](#)

Section 877(c)(2)(B).

[10](#)

Section 877A(g)(1)(B)(ii).

[11](#)

Section 877(c)(3).

[12](#)

Section 877A(g)(3).

[13](#)

Section 877A(g)(4).

[14](#)

Id.

[15](#)

Section 877A(g)(3)(B).

[16](#)

Issued by the Department of Homeland Security, U.S. Citizenship and Immigration Services.

[17](#)

Section 7701(b)(6) as amended by the HEART legislation.

[18](#)

Section 6039G.

[19](#)

Sections 7701(n)(1) and (2) prior to the HEART legislation.

[20](#)

Section 877(h) as added by the HEART legislation.

[21](#)

Section 6039G as amended by the HEART legislation.

[22](#)

Section 6039G(c).

[23](#)

Section 877(g)(1).

[24](#)

Section 877(g).

[25](#)

Section 877(g)(2)(A).

[26](#)

Section 877(g)(2)(B).

[27](#)

The Reed Amendment was included as section 212(a)(10)(E) of the Illegal Immigration Reform and Responsibility Act, enacted in 1996.

[28](#)

Sections 877A(a)(1) and (3). The \$600,000 figure is adjusted for inflation.

[29](#)

If a trust that is a grantor trust immediately before the expatriation date subsequently becomes a nongrantor trust, the trust remains a grantor trust for purposes of Section 877A(f)(1). See 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, 5/20/08).

[30](#)

Covered expatriates who own (1) an IRA, (2) a Section 529 plan, (3) a Coverdell education savings account, (4) a health savings account, or (5) an Archer MSA are subject to the mark-to-

market tax under Section 877A(e)(2). Simplified employee pensions and simplified retirement accounts receive different treatment as deferred compensation.

[31](#)

Section 877A(e)(1)(A).

[32](#)

Section 877A(e)(1)(B).

[33](#)

Section 877A(e)(1)(C).

[34](#)

Section 877A(a)(2).

[35](#)

Section 877A(h)(1)(A). For example, this provision would prohibit a covered expatriate from engaging in a like-kind exchange.

[36](#)

Section 877A(h)(1)(B).

[37](#)

Section 877A(a)(2).

[38](#)

Id.

[39](#)

Section 877A(h)(2).

[40](#)

Id.

[41](#)

Section 877A(h)(3).

[42](#)

There are exceptions, the analysis of which is beyond the scope of this article.

[43](#)

Section 684(b)(2).

[44](#)

Section 877A(b)(1).

[45](#)

Section 877A(b)(7).

[46](#)

Section 877A(b)(3).

[47](#)

Section 877A(b)(6).

[48](#)

Section 877A(b)(4)(A).

[49](#)

Section 877A(b)(5).

[50](#)

Section 877A(b)(4)(B)(i).

[51](#)

Section 877A(b)(4)(B)(ii).

[52](#)

Section 877A(c).

[53](#)

Section 877A(d)(1).

[54](#)

Section 877A(f)(1).

[55](#)

Section 877A(d)(6)(C).

[56](#)

Sections 877A(d)(1)(A) and (f)(1)(A).

[57](#)

Section 877A(d)(3).

[58](#)

Sections 877A(d)(3)(A) and (B).

[59](#)

Section 877A(d)(5).

[60](#)

Sections 877A(d)(1)(B) and (d)(6)(B).

[61](#)

Section 877A(d)(2)(A)(i).

[62](#)

Section 877A(d)(2)(A)(ii).

[63](#)

Section 877A(d)(2)(C).

[64](#)

Section 877A(d)(2)(B).

[65](#)

Section 877A(f)(1)(A).

[66](#)

Section 877A(f)(4)(A).

[67](#)

Section 877A(f)(5).

[68](#)

Section 877A(d)(3)(B)(ii).

[69](#)

Section 877A(f)(1)(B).

[70](#)

See JCX-44-08, *supra* note 29.

[71](#)

Section 877(b)(1).

[72](#)

Section 877(a)(1).

[73](#)

HEART legislation, section 301(g)(2).

[74](#)

Section 2801(e)(1)(A).

[75](#)

Section 2801(e)(1)(B).

[76](#)

Section 2801(b).

[77](#)

Section 2801(a).

[78](#)

Section 2801(e)(3).

[79](#)

Section 2801(e)(2).

[80](#)

Section 2801(d).

[81](#)

Section 2801(c).

[82](#)

Section 2801(e)(4)(A).

[83](#)

Section 2801(e)(4)(B).

[84](#)

Section 2801(e)(4)(B)(ii).

[85](#)

Section 2801(e)(4)(B)(iii).

[86](#)

Section 2107(a).

[87](#)

Section 2103.

[88](#)

Section 2102(b).

[89](#)

Section 2107(c).

[90](#)

Reg. 26.2663-2(b).

[91](#)

Section 2104(a).

[92](#)

Section 2107(b).

[93](#)

Section 2107(b).

[94](#)

"Report of Foreign Bank and Financial Accounts," otherwise known as the FBAR. See generally Packman and Weinstein, "FBAR—Foreign Bank Account Reporting Obligations: A Primer for the Practitioner," 106 JTAX 44 (January 2007).

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