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Expatriating and Its U.S. Tax Impact

BY ROBERT W. WOOD

I try to avoid saying ''for tax purposes'' in most things; although clients tend to use such phrases, the ''for tax purposes'' qualifier often sounds disingenuous—in fact, it can sound downright untoward in some cases.

In the context of expatriations, where there are substantial physical, legal, and perhaps even patriotic implications, the ''for tax purposes'' moniker sounds particularly inappropriate.

It is quite clear that an expatriation is for all purposes, not merely for tax purposes. A prospective client may profess to be interested in expatriating from the United States solely ''for tax purposes.'' I find this reminiscent of a client who does not really want to move states, say from California to Nevada, and who actually intends to remain in the Golden State but to leave ''for tax purposes.'' I would steer clear of such clients.

Sometimes, though, clients mean that they want to expatriate for all purposes, but for tax reasons.

Whatever one's motives, the fact that one leaves the United States does not mean one thereby leaves U.S. tax obligations behind. Even if one renounces U.S. citizenship (or as a noncitizen, gives up U.S. permanent residency), many tax obligations continue. The U.S. tax law governing expatriation has a curious history and is stratified like a geological dig.

The law has changed numerous times over the years. Which set of rules and conditions applies depends on timing and details. The expatriation tax rules have evolved from the era when one could leave the United States permanently without worrying about taxes.

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This discussion is not intended as legal advice, and cannot be relied upon for any purpose without the services of a qualified professional.

Worldwide Income Rule

One must begin from the precept that the United States taxes citizens and permanent residents on their worldwide income. Then, upon death, the United States taxes the value of assets owned by such persons. Although some countries adopt similarly rigorous rules, some do not.

Of course, under the U.S. system, it does not matter in which country one resides, where the income is earned, or where else one might pay tax. The U.S. citizen or permanent resident must report his or her worldwide income for U.S. tax purposes.

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The taxpayer may receive foreign tax credits on his or her U.S. Form 1040 for taxes paid elsewhere. Those credits may offset some (but typically not all) of the burden of paying tax in multiple jurisdictions. Tax treaties may help too, but tax treaties and tax credits rarely serve as a complete fix. A U.S. citizen or permanent resident remains subject to tax in the United States on his or her worldwide income, no matter what.

The Finality of Expatriating

To put oneself beyond the reach of the Internal Revenue Service, a citizen must give up U.S. citizenship. A permanent resident must give up that status.

Moreover, in some cases, return visits will be limited. In the case of persons expatriating after June 3, 2004, and before June 16, 2008, the expatriate must severely limit the time he or she thereafter spends in the United States to not more than 30 days a year for the ensuing

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10 years. A person who attempted to renounce U.S. citizenship but then spends more than 30 days a year in the United States will be treated as a U.S. citizen or resident for that year.

Current law governing a person expatriating after June 16, 2008, is more forgiving about return visits.

Permanent U.S. residents (holding green cards) may find it easier than U.S. citizens to take the expatriation plunge, particularly if family or business opportunities in their country of origin beckon. Yet the tax rules are equally unforgiving.

Prior Law 10-Year Window

The first major regulation of expatriation and its tax effects came in 1966 when Congress enacted the Foreign Investors Tax Act of 1966 (Pub. L. No. 89-809). In general, expatriates were subject to U.S. tax on their U.S.-source income at normal U.S. tax rates for 10 years following their expatriation. Significantly, though, a person could avoid this tax entirely if he or she did not have as one of his or her principal purposes the avoidance of U.S. federal income, estate, or gift taxes.

Few people chose to admit they had a principal purpose of avoiding tax. The government also had a hard time proving it. There were many people (often with good tax lawyers) marrying foreigners, returning to the country of their birth, etc. The system did not work very well, and little tax was collected.

In 1994, the public became increasingly aware that certain wealthy Americans were escaping U.S. income and estate tax by leaving the country. Perhaps the most famous—and famously clever—was Dart Container heir Kenneth Dart. Dart expatriated but managed to come back to the United States from his new home country of Belize as the Belize Ambassador to the United States. Dart occupied a newly opened Belize Embassy in Sarasota, Fla., in the very residence where he had previously lived.

Since that time, and given such apparent chutzpah in the face of otherwise prevalent U.S. tax obligations, it is not surprising that Congress repeatedly tightened the rules on tax-motivated expatriations. Ultimately this evolved into a system that is not influenced by taxpayer motivations or taxpayer-subjective motives.

1996 Changes

Thirty years later, in 1996, Congress again sought to address these issues. As part of the Health Insurance Portability and Accountability Act of 1996 (HIPAA; Pub. L. No. 104-191), Congress added a presumption of tax avoidance if an expatriate's five-year average net income tax exceeded $100,000, or if the expatriate's net worth was $500,000 or more (both adjusted each year for inflation).

Perhaps this tax avoidance presumption seemed sufficient to stem the perceived tide. In practice, however, taxpayers could rebut the tax avoidance presumption. As a result, IRS still had to demonstrate tax avoidance, something that in most cases proved to be difficult.

Tax Avoidance Irrelevant in 2004

In 2004 (in the American Jobs Creation Act (Pub. L. No. 108-357)), Congress discarded tax avoidance motives altogether. Regardless of the reason for the expatriation, the law imposed 10 years of U.S. tax on U.S.-source gross income and gains on a net basis.

Although the tax applied if a taxpayer left the country for any reason, Congress increased the threshold for determining who was subject to this expatriation tax.

Under Section 877 of the Internal Revenue Code, an individual was subject to the expatriation tax only if he had an average net annual income tax for the five years preceding expatriation of $124,000, or if he had a net worth of $2 million or more on the date of expatriation. These thresholds are less clear than one might assume. In some cases, even if a taxpayer fell below these thresholds tax would nevertheless apply.

For example, expatriates must certify their past U.S. tax compliance by filing an IRS Form 8854, Initial and Annual Expatriation Statement. Any expatriate who fails to certify compliance with U.S. federal income tax laws for the five taxable years preceding the expatriation is subject to the expatriate income tax even if the taxpayer failed to meet the income tax liability or net worth tests.

Furthermore, post-expatriation visits had to be monitored. If one expatriated before June 16, 2008 (under the old Internal Revenue Code Section 877 regime), if the expatriate comes back to the United States for more than 30 days in any year during the 10 years following expatriation, that person is considered a resident of the United States for that entire tax year. That means the person would again be subject to U.S. tax on his or her worldwide income, not just his or her U.S.-source income.

Expatriates must certify their past U.S. tax compliance by filing an IRS Form 8854, Initial and Annual Expatriation Statement.

This 30-day rule does, however, have an exception for any days (up to a 30-day limit) that the individual performed personal services in the United States for an employer (who is not related). This exception only applies if that individual either:

- had certain ties with other countries, or
- was physically present in the United States for 30 days or less for each year in the 10-year period following the date of expatriation or termination of residency.

A covered person expatriating after June 3, 2004, but before June 16, 2008, must file an IRS Form 1040NR (U.S. Nonresident Alien Income Tax Return) for each year in the 10-year period following expatriation. The expatriation tax for these filers applies to U.S.-source gross income and gains on a net basis. Thus, the expatriate could not entirely escape IRS until the ensuing 10-year period was up.

Long-Term Residents

It is easy to define who is and is not a U.S. citizen. The term ''long-term resident'' is not quite so clear. A long-term resident is a non-U.S. citizen who is a lawful permanent resident of the United States in at least eight years during the 15-year period before that person's

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residency ends. A ''lawful permanent resident'' means a green card holder.

However, a person is not treated as a lawful permanent resident for purposes of this eight-year test in a year in which that person is treated as a resident of a foreign country under a tax treaty, and who does not waive the treaty benefits applicable to residents of that country.

Caution: Holding a green card for even one day during a year will taint the whole year.

Post-June 16, 2008, Exit Tax

In mid-2008, the rules changed substantially, with the 10-year tax (Section 877) replaced by a one-time exit tax (Section 877A). The Heroes Earnings Assistance and Relief Tax Act of 2008 (generally known as the Heroes Act; Pub. L. No. 110-245) changed the method of taxation for those who became expatriates on or after June 16, 2008, adding more complexity and usually higher U.S. taxes.

If a U.S. citizen or long-term resident expatriates on or after June 16, 2008, he or she is deemed (for tax purposes—but here that moniker truly applies) to have sold all of his worldwide property for its fair market value the day before leaving the United States.

This deemed gain is subject to U.S. tax at the capital gain rate. The gain is taken into account without regard to any ameliorative tax provisions in the Internal Revenue Code. None of the exemptions, exclusions, or nonrecognition or rollover provisions that might provide tax relief will apply.

These helpful (but in this case non-applicable) provisions include, for example, the inability to benefit from the $250,000 per person ($500,000 per couple) exclusion from gain on a principal residence (Section 121) and many other rules. The exit tax is analogous to an estate tax. Just as all assets that would be part of one's estate would be included in one's gross estate, the expatriate's assets will be subject to income tax on unrealized gains as of the day before the person expatriates.

Avoiding Exit Tax

In general, the exit tax is unforgiving and has broad application. Yet there are exceptions from its application.

First, there is the net annual income tax threshold. Under the 2004-2008 expatriation rules (Section 877), an individual was subject to expatriation tax only if he or she had an average net annual income tax for the five years preceding expatriation of $124,000 or if he or she had a net worth of $2 million or more on the date of expatriation. Under Section 877A for current expatriations, the average net annual income tax threshold is $145,000. The $2 million net worth test remains.

Thus, one is subject to the new Section 877A rules if one expatriates on or after June 16, 2008, and any of the following applies:

- Your average annual net income tax for the five years ending before the date of expatriation or termination of residency is more than a specified amount adjusted for inflation ($145,000 for 2009 and 2010; $147,000 for 2011).
- Your net worth is $2 million or more on the date of expatriation or termination of residency.
- You fail to certify on Form 8854 that you have complied with all U.S. federal tax obligations for the five years preceding the date of your expatriation or termination of residency.

There is also a gain on sale threshold. If a taxpayer has less than $600,000 of income from the deemed sale of assets on expatriation, there is no tax due. This exemption amount is adjusted for inflation (it was $627,000 for 2010 and $636,000 for 2011). If the expatriate's gain exceeds this amount, he or she must allocate the gain pro rata among all appreciated property.

However, this exclusion amount must be allocated to each item of property with built-in gain on a proportional basis. This involves a complicated process of multiplying the exclusion amount by the ratio of the built-in gain for each gain asset over the total built-in gain of all gain assets. The exclusion amount allocated to each gain asset may not exceed the amount of that asset's built-in gain.

Moreover, if the total allowable gain of all gain assets is less than the exclusion amount, the exclusion amount that can be allocated to the gain assets will be limited to that amount of gain. For example, in 2011, if the total allowable gain in an expatriate's assets was $500,000, then that $500,000 would be the limit instead of $636,000.

Under prior law, the taxpayer generally had to give notice of expatriation to trigger the rules. Under current law, if one relinquishes a passport or green card, the rules generally operate automatically. Nevertheless, even under the current law, some expatriates are able to escape the exit tax.

First, there are the financial thresholds. Furthermore, some people born with dual citizenship who have not had a substantial presence in the United States and certain minors who expatriated before the age of 18½ are also exempt. However, those people must still file an IRS Form 8854.

Elective Deferral

Taxpayers who are subject to the exit tax are entitled to make an irrevocable election (on a property-by-property basis) to defer the tax until actually selling the property. This election allows people to leave the United States and expatriate without triggering immediate tax as long as IRS is assured it will collect the tax in the future. In that sense, the election removes the liquidity burden of the immediate deemed sale.

To qualify, a covered expatriate must provide a bond or other adequate security for the tax liability. There are specific requirements for these security bonds. In addition, there is updating and monitoring of the bond in case it becomes inadequate to cover the tax.

Detailed requirements apply to the deferral election, including copies of various documents that must accompany it.

One of these requirements is appointing a U.S. agent for the limited purpose of accepting communications with IRS. The taxpayer must also waive any tax treaty benefits that might otherwise impact IRS getting its money.

Some taxpayers may want to consider possible rate changes. If you defer the tax now, when you do sell, you would pay taxes at the rate then in effect. They could well be higher than the present capital gain rates.

As you might expect, there are forms to file and procedures to follow if you expatriate. You must file IRS Form 8854 (in some cases for 10 years). Additional special forms (Form W-8CE if you have any deferred compensation items, a specified tax deferred account, certain non-grantor trusts, etc.) are also required. A good source is IRS Notice 2009-85, available at http://www.irs.gov/irb/2009-45_IRB/ar10.html.

Conclusion

The tax rules regarding expatriation for citizens and long-term residents are complex. Professional help is clearly necessary. Do not leave home without it.

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