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Renounce U.S., Here's How IRS Computes 'Exit Tax'

There is considerable talk today about leaving America, and the head count is up. Of course, the numbers are still small compared to those who are arriving. And despite the rhetoric, it is rarely political. Some of it is about family, and about the pressures of America's global tax reporting and compliance regime, including FATCA (the Foreign Account Tax Compliance Act).

Giving up a U.S. passport is not to be taken lightly, nor is giving up a long term (8 years or more) green card. For some, there is even an IRS tax on your exit. You pay tax on all your income every year. The Exit Tax is like an estate tax on the gain in your assets, even though you are not actually selling anything. It is the IRS's last chance to tax you.

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The Exit Tax is computed as if you sold all your assets on the day before you expatriated, and had to report the gain. Currently, net capital gains can be taxed as high as 23.8%, including the net investment income tax. For a time, Congress talked of hiking the tax to 30% after Eduardo Saverin of Facebook fame took off for Singapore. Still, 23.8% is nothing to sneeze at. There are three triggers for the Exit Tax, and any one of them will make you a “covered expatriate.”

First, is your net worth over $2 million? This is the aggregate net value of worldwide assets. It is not just your U.S. assets. For married taxpayers, each spouse’s net worth is calculated separately from the other. If they own their assets relatively equally, a married couple could have a total net worth of up to $4 million without triggering the Exit Tax.

On the other hand, if one spouse owns most of the assets, that spouse could be a covered expatriate, even if the other spouse owns significantly less than $2 million of assets. Thankfully, some couples can gift assets to each other to bring both spouses’ net worths to below $2 million. If the spouse receiving the gifts is a U.S. citizen, these gifts may escape U.S. gift tax.

On the other hand, if the spouse receiving the gift is not a U.S. citizen, spousal gifts may be subject to gift tax even if the spouse receiving the gift is a U.S. green card holder. For 2017, there is an annual exclusion of $149,000 for gifts to non-citizen spouses. If you need to transfer more than that amount to your spouse to bring your net worth to below $2 million, you would have to rely on your unified tax credit to avoid gift tax, or you would need to plan in advance to make the transfers over multiple years before expatriating.

Second, is your average net annual income tax liability over $162,000? This is not your taxable income, but your *tax liability* on that income. If you are married and filing taxes jointly, you must use your net tax liability on your *joint* returns, even if only one of you is expatriating. This trigger can sometimes be avoided with careful planning. Filing separate tax returns (not joint returns) often makes sense. As the trigger is your *average* tax liability over the last five years, you may need to file separately for several years before you expatriate.

The third way you can be a covered expatriate is if you do not (or cannot) certify five years of U.S. tax compliance. If you haven’t filed, or haven’t filed properly—say you didn’t report an offshore bank account—you will need to fix that too. Fortunately, you can amend your prior tax returns (and other forms) and simultaneously also file a Form 8854 to expatriate. In effect, you sign your Form 8854 last, *after* you’ve signed the amended tax documents.

What if you trip any of these tests? You should calculate the Exit Tax. If you are *not* a covered expatriate, it does not matter. If you *are* a covered expatriate, the first *$699,000* of gain is shielded from the Exit Tax for 2017 expatriations. For spouses who expatriate, each spouse files a separate Form 8854, and each spouse can exclude $699,000 of gain (or nearly $1.4 million of gain combined). The Exit Tax on certain assets, notably 401(k) plans, can be deferred.

Thus, you may not have to pay the Exit Tax on the plans' values when you expatriate, and would only pay U.S. tax on the 401(k) plan as distributions are made out of the plan. However, the tax on the future distributions is generally 30%, and you cannot claim a treaty benefit to reduce the tax. For most other assets, you can make an irrevocable election to defer payment on the Exit Tax owed. Still, the IRS wants a bond or adequate security for any deferred Exit Tax, and interest accrues until it is paid.

Even if a covered expatriate has less than $699,000 of gain in his or her assets, being a covered expatriate has negative consequences. If you have friends or family in the U.S., being a covered expatriate could result in your gifts to them coming with a tax bill that *they* would have to pay. Even if your Exit Tax may be slight, or you would not owe any Exit Tax (for example, because of the $699,000 gain exclusion), avoid being a covered expatriate if you can. A goal of many expatriating taxpayers is to have a final, clean break from the U.S. tax system.

For alerts to future tax articles, email me at Wood@WoodLLP.com. This discussion is not legal advice.