The new US exit tax scheme: breaking off a long-term relationship with Uncle Sam

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Abstract

The US ‘alternative tax regime’ in place since 17 June 2008 captures both US nationals who renounce citizenship and long-term residents who give up their ‘Green Cards’. The scheme subjects their non-retirement assets to an immediate mark-to-market tax on unrealized gains and levies other immediate or deferred income taxes on retirement assets. Furthermore, there is a new inheritance tax on the recipients of certain gifts or bequests from an expatriate. Creative planning, however, can circumvent the taxes entirely or at least ameliorate their effect. The ‘expatriation trust’ is the primary vehicle for providing relief.

For several decades, the US Government has imposed an ‘alternative tax regime’ on its citizens who relinquish their passports.1 In 1996, the regime was extended to certain non-citizens who give up their permanent resident cards, which are commonly referred to as ‘Green Cards’.2 Until 17 June 2008, this alternative tax regime merely expanded the items of US-sited property against which any other non-US persons would pay tax, whether income tax or various taxes on gratuitous transfers.3 For renunciations of citizenship and permanent resident status occurring on or after that date, however, the scheme is completely different and, for many unhappy expats, very expensive.4

The new scheme involves two immediate exit taxes, two further income taxes that may come due later, and an inheritance tax on subsequent transfers by the expatriate. Before addressing the specifics of these taxes, this article treats the threshold question of who qualifies as a ‘covered expatriate’ for purposes of exposure to the scheme. The article next addresses the various taxes under the headings of ‘immediate income taxes,’ ‘deferred income taxes’, and ‘inheritance tax’. The possibility of treaty relief is then considered. The article concludes with advice on legitimately avoiding the taxes.

The ‘covered expatriate’

The new alternative tax regime ensnares certain nationals who renounce citizenship and long-term residents who turn in, or are deemed to have turned in, their permanent resident cards. In either case, they are considered to be ‘expatriates’. In order to qualify as a ‘covered expatriate’, the person must meet either a net worth test or a tax liability test.

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The net worth test is met if the fair market value of person’s worldwide assets, as of the expatriation date, equals or exceeds USD 2,000,000.5 The advisor must use ‘good faith estimates’ for hard-to-value assets.6 Furthermore, the scheme looks through beneficial interests in certain trusts and requires valuation of the interests.7 In order to value a beneficiary’s interest in a trust, there is a vague facts-and-circumstances analysis that takes into account the terms of the trust instrument, any letter of wishes, and historical patterns of distributions.8 If these factors fail to produce a reliable valuation, then the expatriate must consider the amount he or she would receive if the trust terminated and the rules of succession applied, as if the settlor died without a will in place.9 The rules on valuation of a beneficial interest in a trust will likely apply to an interest in a Stiftung.10 Pity the task of the expatriate’s advisor when the valuation rules do not produce a clear answer on whether to file with the Internal Revenue Service (IRS) as a covered expatriate or not.

The tax liability test is more workable. It looks to the expatriate’s average US income tax liability over the previous five calendar years.11 If the average tax exceeds an inflation-adjusted threshold, the person is considered a covered expatriate. For expatriations occurring in 2012, the amount is USD 151,000.12 A non-compliant taxpayer will nonetheless be classified as a covered expatriate even if he or she does not meet the net worth test or the tax liability test. A further ‘certification test’ provides that if the taxpayer fails to certify under penalty of perjury that he or she is fully compliant with US tax obligations over the preceding five calendar years, the taxpayer becomes a covered expatriate.13

There are two very narrow exceptions to covered expatriate status for an otherwise qualifying US national. The more likely exception to apply aims to exempt persons who were born into dual citizenship. In order to be exempt, however, the person must never have been a resident of the United States for income tax purposes, must never have held a passport and, over the previous 10 years, must not have been present in the United States for more than 30 days.14 The other exemption involves minors with insubstantial connections to the United States.15

As for permanent residents who give up the Green Card (or are deemed to have done so) and who otherwise qualify as a covered expatriate under the net worth, tax liability, and certification tests, they will be classified as covered expatriates if they meet the 8-of-15 test. Under this analysis, the permanent resident must have held the Green Card for 8 of the previous 15 calendar years.16 The noteworthy trap in this regard is that any one day of permanent residence status during a calendar year counts as a full year.17 For example, if the date of issuance of a person’s Green Card is 31 December 2005 and the person subsequently renounces it on 1 January 2012, the unfortunate soul qualifies under the 8-of-15 rule.

5. IRC s 877(a)(2). The USD 2,000,000 threshold is not adjusted for inflation.
6. United States Internal Revenue Service (IRS) Notice 97-19, 1997-1 Cumulative Bulletin 394, Sec III. This Notice is subsequently cited as ‘Notice 97-19’. The ‘Cumulative Bulletin’ is hereafter cited as ‘CB’.
7. ibid.
8. ibid.
9. ibid.
10. See IRS Associate Chief Counsel (Passthroughs & Special Industries) Memorandum, AM 2009-012 (7 October 2009).
11. IRC s 877(a)(2).
13. IRC s 877(a)(2).
14. ibid, s 877(c)(2).
15. If these persons have had little contact with the United States in the 10 years prior to reaching the age of majority (regardless of length of time spent in the United States during the first eight years of life), they will be exempt upon expatriation if certain criteria are met. IRC s 877(c)(3).
16. IRC s 877(e).
Although a permanent resident can ‘expatriate’ by the affirmative act of taking the Green Card to an American consulate and filling out a form,\(^{18}\) he or she can also expatriate inadvertently. In the case of a permanent resident who moves to a country that has an income tax treaty with the United States, the person is deemed to have expatriated simply by filing a US income tax return and taking advantage of the treaty, perhaps to achieve a lower rate of taxation on US-source dividends.\(^{19}\) Given the penalties for failure to file an expatriation return with the IRS and the interest due on unpaid taxes, the inadvertent mistake can make an already expensive tax all the more costly.\(^{20}\) And considering that the United States has income tax treaties with over 60 nations, the likelihood of inadvertence is not remote.\(^{21}\) The fairness of such a scheme is difficult to justify.

Because American corporations need the talents of permanent residents, it remains an open question of policy as to why the US Congress would want to tax them when they determine to go back home, perhaps after many years of dedicated service. Others may have been awarded a Green Card, perhaps in the annual ‘lottery’, but have never settled in the States. Query the legitimacy of a regime that would tax them upon renunciation.

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The taxes

The immediate income taxes

The two most notorious taxes will apply immediately upon expatriation.

The mark-to-market tax

The first is the flagship tax of the new alternative tax regime: the ‘mark-to-market tax’ on deemed gains.\(^{22}\) The tax applies to the worldwide assets of the covered expatriate, except to the extent that an asset falls within one of the other taxing categories, discussed below.\(^{23}\) To calculate the tax, the expatriate takes each includible asset and ‘marks it to the market’, as if the asset had been sold by the taxpayer at fair market value on the day before the expatriation date.\(^{24}\) From this value, the expatriate subtracts the basis of the asset, which is usually the cost of its acquisition.\(^{25}\) If there are unrealized losses attributable to some assets, the losses are netted against the gains on assets within the same tax categories as the assets that produced the losses.\(^{26}\)

If there is any good news for the expatriate in the new alternative tax regime, it is the exemption against

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19. IRC s 7701(b)(6) (flush language). See also IRS Notice 2009-85, 2009-45 I.R.B. 598 (hereinafter ‘Notice 2009-85’), s 2.A. This type of expatriating event is an attempt to synchronize the expatriation rules with existing bilateral income tax treaties. The Regulations under IRC s 7701(b)(6) refer to a ‘dual resident taxpayer’, ie an individual who is considered to be a US resident for income tax purposes under federal tax law and is considered to be a resident of the treaty country pursuant to that country’s internal law. These long-standing Regulations were issued for purely income tax reasons to solve the problem of the individual who is a resident of two countries for income tax purposes and seeks relief from taxation by the IRS under a treaty. The Regulations provide a mechanism for electing into treaty benefits when the individual can validly claim that, under the tie-breaking scheme for settling residency under the treaty, the he or she is a treaty resident of the other country for any tax year or portion of a tax year. For that year or portion of that year, the person is free to calculate US income tax liability as a nonresident alien (which generally limits US taxation to US-source income) and as permitted under the treaty (which typically provides for a reduced rate of taxation on US-source income). Treas. Reg. s 301.7701(b)-7(a).
20. For example, IRC s 6039G(c) imposes a penalty of USD10,000 for failure to file.
22. IRC s 877A(a).
23. ibid; Notice 2009-85, s 3.A.
24. ibid.
25. If, however, the acquisition cost of a long-term resident is higher than the fair market value of the asset on the date the taxpayer became a permanent resident, the lower value is used. The expatriate, however, can elect out of such treatment if it benefits him or her on a cumulative (not asset-by-asset) basis. IRC s 877A(b)(2).
26. IRC s 877A(a)(2)(A). For example, ‘long-term capital losses’ would be netted against ‘long-term capital gains’. 
the gain on which the mark-to-market tax is calculated.\textsuperscript{27} This exemption is an inflation-adjusted figure which, for expatriations occurring in 2012, equals USD 651,000.\textsuperscript{28} Given that the United States currently and historically imposes lower tax rates on gains with respect to a category of capital assets held for a sufficient period of time, the news would be better if the taxpayer could allocate the exemption to the deemed gain inherent in other asset categories, such as non-capital assets. The exemption, however, must be applied \textit{pro rata} to all assets producing gain.\textsuperscript{29}

The valuation of assets under the mark-to-market scheme is made as of the day before the 'expatriation date'.\textsuperscript{30} For the person who renounces US citizenship, the date typically corresponds to day on which the individual renounces US nationality before a diplomatic or consular officer, which act will be subsequently confirmed by the US Department of State’s issuance of a certificate of loss of nationality.\textsuperscript{31} For the long-term resident, it is normally the date on which the person appears before a US consular officer with an Application for Abandonment of Lawful Permanent Residence Status.\textsuperscript{32} Query as to the expatriation date when the long-term resident inadvertently expatriates by taking a treaty-based return position on a US income tax return. Although the IRS has not issued guidance on this issue, the date would most likely be the day on which the resident finally departed the United States and made the other country his or her domicile.\textsuperscript{33}

How would the mark-to-market tax apply to assets held in trust? If the expatriate settled the trust, the inclusion of the trust’s assets as part of the property subject to tax would depend on the degree of control that the settlor retained over the trust. In this regard, the analysis turns to whether the trust assets would be includible in the expatriate’s US estate for transfer tax purposes (the US estate and gift taxes).\textsuperscript{34} If, for example, the trust were revocable, the trust’s corpus would be property subject to the mark-to-market scheme.\textsuperscript{35} In the case of an irrevocable trust, a reserved income interest or the reserved right-to-use trust property would cause inclusion as well.\textsuperscript{36} A reserved power to appoint trust assets by deed or by will would further subject the corpus to the tax.\textsuperscript{37} And, to the extent that the settlor’s creditors would have the right to reach the trust’s assets under applicable local law, the corpus would be includible.\textsuperscript{38} This would be the case under the law of most States of the United States, where the American rule against self-settled spendthrift trusts applies.

If the expatriate is not the settlor of the trust, the taxation scheme would include all or any part of the trust over which the expatriate-beneficiary would

\begin{itemize}
\item \textsuperscript{27} IRC s 877A(a)(3).
\item \textsuperscript{28} Rev Proc 2011-52.
\item \textsuperscript{29} Notice 2009-85, s 3.B.
\item \textsuperscript{30} IRC s 877A(a)(1).
\item \textsuperscript{31} ibid, s 877A(g)(4).
\item \textsuperscript{32} See note 18 above.
\item \textsuperscript{33} By statute, it is the date on which the
‘individual commences to be treated as a resident of a foreign country under the provisions of a tax treaty between the United States and the foreign country, does not waive the benefits of such treaty applicable to residents of the foreign country, and notifies the [US Treasury] Secretary of the commencement of such treatment’.
\item IRC s 7701(b)(6) (flush language). \textit{See also} Notice 2009-85, Section 2.A. This happening can be referred to as the 'Tax Treaty Event'. The Tax Treaty Event is an attempt to synchronize the expatriation rules with existing bilateral income tax treaties. See note 19 above for an explanation of this concept. This mechanism for electing into treaty benefits was picked up by the former alternative tax regime as establishing the expatriation date, which is important for purposes of marking the 10-year period of enhanced US income taxation. Similarly, the new alternative tax regime uses this same mechanism for determining the expatriation date for all purposes, including the valuation date under the mark-to-market tax. The election by a dual-resident, Green-Card-holding taxpayer into treaty benefits serves as an act of expatriation (the Tax Treaty Event). The expatriation date (the date the ‘individual commences to be treated as a resident of a foreign country under the provisions of a tax treaty between the United States and the foreign country’) would most likely be the date on which the taxpayer, having affirmatively left the United States, with spouse and children or other significant persons, arrived in a treaty country and began making a home there.
\item \textsuperscript{34} Notice 2009-85, Section 3.A.
\item \textsuperscript{35} IRC s 2038.
\item \textsuperscript{36} ibid, s 2036(a)(1).
\item \textsuperscript{37} ibid, s 2041.
\end{itemize}
need to include under US transfer tax principles. Powers that typically cause inclusion are a power of withdrawal or a general power of appointment under the terms of the trust.\textsuperscript{39} In US trusts, a typical type of power granted to a beneficiary is the right to withdraw, on an annual basis, five per cent of the value of the trust corpus. If the five-per cent withdrawal power goes unexercised, the power to withdraw for that year typically lapses. In the year of death (or of expatriation under the exit tax scheme), five per cent of the trust’s asset value would be includable in the tax base because the withdrawal right had not yet lapsed.\textsuperscript{40} To the extent that assets within a trust are includible in the mark-to-market tax base, it is not clear how the taxpayer is to determine the amount of inherent gains and losses. In the case of a wholly includible trust, it would seem that the taxpayer would look to the basis of the asset in the hands of the trustee. For partially includible trusts, perhaps a proportional part of the inherent gain or loss within each trust asset is considered.

To the extent that all or a part of the trust corpus would not be included in the tax base after application of the principles of the US transfer tax system, the scheme then looks to the expatriate’s beneficial interest in the trust as an interest which can be valued and taxed.\textsuperscript{41} In this regard, the Internal Revenue Code makes a distinction between beneficial interests in ‘non-grantor trusts’ and ‘grantor trusts’, which are US income tax concepts explained further below. If the beneficial interest is in a ‘non-grantor trust’, the interest will not be subject to the mark-to-market tax.\textsuperscript{42} This exclusion is not an act of clemency by the US Congress, as interests in non-grantor trusts are subject to a separate section of the exit tax scheme which is explained further below under the heading ‘tax on distributions from non-grantor trusts’. The value of the beneficial interest of the expatriate in a ‘grantor trust’ must be included in the mark-to-market tax base.\textsuperscript{43}

An understanding of the distinction between a ‘grantor trust’ and a ‘non-grantor trust’ requires a fairly sophisticated grounding in the sections of the Internal Revenue Code known as ‘Subpart E’. A grantor trust is a type of fiscally transparent structure whereby the settlor of the trust is charged with all of the income earned within it. For US income tax purposes, the grantor trust has no existence separate from its settlor (its ‘owner’ in US tax parlance). If, for example, it is possible for the settlor or the settlor’s spouse to receive a distribution of income or principal without the consent of a beneficiary with an adverse interest in such distribution, the trust would be considered ‘grantor’.\textsuperscript{44}

In contrast, a non-grantor trust is a taxpayer in its own right. It has a fiscal existence separate from the settlor. These types of trusts are only transparent to the extent that certain items of distributed income such as interest, dividends, and rents are taxed to the trust’s beneficiaries.\textsuperscript{45} Otherwise, the trust pays tax, such as on capital gains and on accumulations of income. The assets within a non-grantor trust, which would not otherwise be includible in the covered expatriate’s taxable estate for transfer tax purposes, do not form part of the base for mark-to-market tax purposes.

When a market-to-market tax is due, there is a mechanism for deferring payment, but it is quite cumbersome.\textsuperscript{46} For example, security for the tax must be pledged.\textsuperscript{47}

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\begin{enumerate}
\item \textsuperscript{39} IRC s 2041.
\item \textsuperscript{40} Rev Rul 79-373, 1979-2 CB 331.
\item \textsuperscript{41} Notice 2009-85, Section 3.A.
\item \textsuperscript{42} ibid.
\item \textsuperscript{43} ibid. As before, there is no guidance from the Internal Revenue Service on how determine the inherent gain or loss trapped within trust assets. See text following note 40 above.
\item \textsuperscript{44} IRC s 677(a).
\item \textsuperscript{45} ibid, s 661.
\item \textsuperscript{46} ibid, s 877A(b).
\item \textsuperscript{47} ibid, s 877A(b)(4).
\end{enumerate}
\end{footnotesize}
The tax on specified tax deferred accounts

The ‘tax on specified tax deferred accounts’ targets several tax-deferral mechanisms, which are widely used by American citizens and residents. The major one is the individual retirement account (IRA).48 These accounts have typically been funded with pre-tax dollars and, as a result, the holders pay income tax at ordinary, non-preferred rates on all distributions.49 Because IRAs are a retirement savings scheme, the money typically comes out over the period of the taxpayer’s retirement. Upon expatriation, the covered expatriate is treated as having taken a full distribution of all IRAs.50 The result is a tax at non-preferred rates on the entire account balance. Unlike the mark-to-market tax, there is no exemption against the tax on specified tax deferred accounts, and there is no prospect for tax deferral. The full tax is due on 15 April of the year after expatriation occurs.

Deferred income taxes

There are two other income taxes that come due later. These are the ‘tax on deferred compensation items’ and the ‘tax on distributions from non-grantor trusts’.

Tax on deferred compensation items

The exit tax scheme refers to employer-provided retirement plans as ‘deferred compensation items’.51 The value of the account or the benefit stream is taxed under the regime, but in most cases the tax is deferred until distributions actually occur.52 At that time, the provider withholds tax at the rate of 30 per cent.53 This aspect of the regime captures many popular retirement plans, whether provided by for-profit companies, government bureaus, or charities and foundations.54 In order to benefit from deferred taxation of distributions as opposed to immediate taxation of the entire account or the present value of the accrued benefit, the covered expatriate must make an irrevocable waiver of any right under a treaty to claim a reduction in withholding on the item.55

Tax on distributions from non-grantor trusts

If the covered expatriate is the beneficiary of a non-grantor trust and the value of the trust corpus is not taxable under the mark-to-market regime, then the trustee must withhold 30 per cent of the portion of any distribution to the expatriate that would be taxable to a citizen or resident of the United States.56 Such portion would include amounts attributable to tax accounting income such as dividends, interest, and rents.57 The expatriate cannot claim a treaty benefit as a means of reducing the withholding rate.58

Inheritance taxes

The new regime imposes a tax on certain US recipients of inter vivos gifts and testamentary bequests that are made by a covered expatriate, and such tax is imposed regardless of the situs of the transferred assets.59 Such a transfer is referred to in the Internal

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48. ibid, s 408.
49. ibid. An exception to taxability on distributions is the ‘Roth IRA’, which has already been subjected to income tax at an earlier date, resulting in tax-free build-up within the account. IRC s 408A.
50. IRC s 877A(d)(1)(A).
51. ibid, s 877A(d)(4).
52. ibid, s 877A(d)(1).
53. ibid.
54. Examples include a qualified pension, profit-sharing or stock bonus plan under IRC s 401(a); a qualified annuity plan under IRC s 403(a); a s 403(b) annuity (a ‘tax-sheltered annuity’ or TSA) offered through nonprofits, governments (state and local), and educational organizations; simplified employee pensions under IRC s 408(k); SIMPLE retirement accounts under IRC s 408(p), and a foreign retirement plan (but in this case and in the case of any other deferred compensation item, the tax will not apply to the extent that the services were performed outside the US while the person was not a citizen or resident of the US IRC s 877A(d)(5)).
55. IRC s 877A(d)(3)(B).
56. IRC s 877A(f)(1)(A), (f)(2). Furthermore, if the distribution is in kind, the trustee pays a mark-to-market tax on unrealized gain that is separate from the main mark-to-market tax under IRC s 877A(a). IRC s 877A(f)(1)(B).
57. ibid; cf IRC s 871.
58. IRC s 877A(f)(4)(B).
59. ibid, s 2801(a), (c)(4).
Revenue Code as a ‘covered gift or bequest’. There is no time limitation after expatriation which would cut off exposure to this tax.

If the recipient of the gratuitous transfer is a US citizen or individual non-citizen resident, the recipient pays an inheritance tax at a current rate of 35 per cent. The only exemption applicable to such a transfer is an inflation-adjusted annual exclusion, which is currently USD 13,000.

A covered gift or bequest received by a domestic US trust is taxable to the trustee. In this case, it is irrelevant whether the trust itself actually has beneficiaries who are US citizens or residents. A ‘domestic trust’ is one that meets two criteria. First, a US federal or state court is able to exercise primary jurisdiction over the administration of the trust. Second, a ‘United States person’ (generally, a US citizen or resident or a US domestic corporation) has the authority to control all substantial trust decisions, which would necessarily include decisions made by trustees, advisors, and protectors.

In a nod to its limited jurisdiction over contributions by a covered expatriate to a foreign trust, the US government imposes the inheritance tax on a US citizen or resident recipient of a distribution from a foreign trust, so long as the distribution is attributable to a contribution by the covered expatriate to the trust. The IRS has not issued guidance on the rules for making such an attribution. Because the taxpayer is the recipient of the distribution, he or she may have substantial difficulty determining the nature of it. Such a recipient, regardless of the applicability of the exit tax scheme, already has severe reporting requirements and disadvantageous US income tax treatment as a beneficiary of a foreign trust. The extra layer of compliance and tax in the event of a distribution attributable to a contribution by the expatriate will not be welcome. The only solace is that the inheritance tax payable on the receipt is deductible in calculating the income tax due.

**Treaty relief?**

In facing the new exit tax scheme, the first reaction of an advisor to a covered expatriate may be to repair to the nearest available income tax treaty or estate and gift tax treaty. Such an endeavour, however, will produce limited relief.

With the exception of the inheritance tax, the taxes that comprise the expatriation scheme are income taxes. Nearly every American bilateral income tax treaty contains a ‘savings clause’ by which the US retains the right to tax former citizens and long-term residents for a period of 10 years after expatriation. The 10-year period of continued taxation serves to totally deny relief to the expatriate who faces the immediate exit taxes, namely, the mark-to-market tax and the tax on specified tax deferred accounts. Furthermore, under the scheme that grants deferred taxation of employer-provided retirement plans until the time when withdrawals take place, which could occur after 10 years, the expatriate must nevertheless waive tax treaty benefits in order to avoid

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60. ibid, s 2801(e).
61. ibid, s 2801(a), (b).
62. ibid, s 2801(c); Rev Proc 2011-52.
63. IRC s 2801(e)(4)(A).
64. ibid, s 7701(a)(30)(E).
65. ibid. For the definition of the term ‘United States person,’ see IRC s 7701(a)(30).
66. IRC s 2801(e)(4)(B).
67. ibid, s 665–67, 6048.
68. ibid, s 2801(e)(4)(B)(ii).
immediate taxation. Similarly, with respect to the withholding tax on distributions from a non-grantor trust to a covered expatriate, he or she is precluded from claiming a treaty benefit that would reduce the rate of withholding.

The inheritance tax component of the exit tax regime is a tax on gratuitous transfers, so the advisor would look into an available estate and gift tax treaty. Before consulting such a treaty, however, the advisor should note that the US inheritance tax grants a full credit for foreign estate, gift, or inheritance tax on the transfer. Nonetheless, the covered expatriate may have taken up residence in a treaty country that would not tax the transfer or would tax it at a lower rate. For example, Austria has repealed its gift and inheritance tax system. Germany currently affords a EUR 500,000 exemption to each immediate heir and taxes at a 30 per cent rate up to EUR 6,000,000 (and at higher rates beyond). In these events, absent treaty relief, the United States would impose some or all of its 35 per cent tax.

Many of the bilateral estate and gift tax treaties afford the US-continued taxing rights over its expatriates, whether former citizens or long-term residents, but only for a period of 10 years after expatriation. During this 10-year period, treaty relief would be largely non-existent. Afterwards, however, the treaty can be applied. In the case of the US–UK treaty, the United States did not reserve taxing rights over former citizens and non-residents, so immediate relief should be available.

Planning to avoid the taxation scheme

A US citizen or long-term resident who is facing the tax upon expatriation would be well advised to plan to avoid it. Consultation should begin before the person departs the United States. A few strategies are next considered.

Gratuitous transfers to reduce net worth

Unless the person has been paying very substantial US income taxes or has not been tax compliant over the previous 5 years, the reduction of one’s worldwide net worth below USD 2,000,000 before departing the United States will serve to avoid the exit tax scheme altogether. In some situations, the person can simply give away wealth to heirs or charities. In the case of non-charitable gifts, however, the person is limited to a lifetime aggregate gift tax exemption of, under 2012 US law, USD 5,120,000. This exemption applies to all gifts made by the donor to any non-charitable person during his or her lifetime; it does not apply on a per-donee basis as is the case under typical inheritance tax regimes. The exemption is enjoyed by US citizens and residents alike. The strategy of reducing net worth through gifting, however, works in the case of non-retirement assets only. Because of income tax ramifications and legal restrictions, it is impractical to give away retirement plan assets during life. Expatriates with substantial retirement assets are faced with very limited, if any, planning options.

70. See note 55 above.
71. See note 58 above.
72. IRC s 2801(d).
75. Convention for the Avoidance of Double Taxation with respect to Taxes on Estates, U.S.-U.K. (adopted 19 October 1978) 1182 UNTS 83. There is one author who takes the position that treaty relief is never available to an expatriate under the US inheritance tax because, in his view, the treaties give relief to only transferors and never to transferees. T Bissell, 907-3rd Tax Memorandum, US Income Taxation of Nonresident Alien Individuals (Bureau of National Affairs 2010). A literal reading of the treaties consulted by this author, however, does not bear out this contention. The treaties treat the transfer, regardless on whom the relevant taxes are imposed. Indeed, eg the US–Germany treaty provides that it applies not only to the US estate, gift and generation-skipping taxes and the German gift and inheritance taxes, but to ‘any similar taxes on estates, inheritances, and gifts which are imposed after the date of signature of the Convention in addition to, or in place of, the existing taxes’. See, eg US—Germany Treaty, art 2.
76. IRC s 2010; Rev Proc 2011-52. Under current law, the exemption is scheduled to be reduced to USD 1,000,000 on 1 January 2013. Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub L 111-312.
77. IRC ss 2001ff, 2501ff.
with respect to that part of their wealth. Given the limited yearly contributions to retirement accounts permitted under US tax law, however, it is unlikely in most cases that the retirement assets will put the taxpayer over the USD 2,000,000 threshold.

In the case of a long-term resident (as opposed to a US citizen) who departs the United States to a jurisdiction that does not have a gift tax, a similar strategy can be employed. The person, after establishing domicile abroad, but before renouncing permanent resident status or causing expatriation by taking advantage of an income tax treaty, can give away assets to heirs to reduce net worth below USD 2,000,000. This strategy is not available to a departing US citizen, because the United States reserves fully taxing rights over its nationals wherever they may go. Although a Green Card holder is a US income tax resident for as long as the card is held, the residency definition is different under the transfer tax regime. For these purposes, residency is defined in a manner similar to domicile under the Anglo-American common law concept: a person becomes a domiciliary in a place by living there, even if for a brief period, with no present intention of leaving there, and a later intention to change domicile will not be effective unless the person actually leaves. If the long-term resident leaves and definitively establishes a household in a new country, especially when the American dwelling is vacated or sold, the person is no longer a transfer-tax resident of the United States. As a result, the US gift tax will not apply at all, regardless of the amount of the gifts.

For most people, however, the outright transfer of wealth is an unacceptable solution. In these cases, the advisor should consider the employment of an Expatriation Trust in order to avoid the exit tax scheme or at least mitigate its consequences.

A period between establishing domicile abroad and making the gift is advisable, so as to allow the domicile to ripen in the eyes of the IRS. Furthermore, during this ripening period, it is not advisable for the person to use his or her permanent resident card to enter or attempt to enter the United States. Such an action, ie using the card to return to the States as a 'lawful permanent resident,' would be inconsistent with the person’s position that he or she is a domiciled abroad. Furthermore, US Customs and Border Protection (US CBP) may not allow entry and may confiscate the card after a hearing before an immigration judge. In fact, US CBP could interpret presentation of the permanent resident card as immigration fraud, thereby making the person permanently inadmissible to the United States if the judge finds fraud (after any relevant appeal). A charge of immigration fraud would be based in the foreign national’s presentation of the card to gain entry when he or she has no actual intention of continuing to permanently reside in the United States. If this occurs, the person will likely have ‘expatriated’ for tax purposes before he or she made the gifts that were necessary to reduce net worth. A person is advised to consult a US immigration lawyer before renouncing or using the Green Card if he or she needs to reenter the United States. See generally, D Halpert and MJ Stegman, 'Should I Stay or Should I Go: Tax and Immigration Considerations for U.S. Permanent Residents and Citizens' (2011) 4 Bloomberg Law Reports – Immigration. The author acknowledges Mr Halpert’s assistance with this footnote.

Transfers to an ‘Expatriation Trust’
To reduce net worth below USD 2,000,000

In essence, an Expatriation Trust is an irrevocable trust under which an independent trustee or trust advisor has the complete discretion to accumulate assets or to distribute assets among a class of beneficiaries consisting of the settlor, the settlor’s spouse (if desired), and the settlor’s heirs or other objects of bounty. The inclusion of the settlor in the class of beneficiaries would likely make such a structure more palatable than an outright gift of assets to an heir.

The Expatriation Trust, however, must have other crucial characteristics in order for a transfer to it to be effective in reducing the taxpayer’s net worth to below USD 2,000,000. First, it must be a ‘non-grantor trust’ for US income tax purposes. If not, the IRS will consider all assets in the trust to be includible when calculating net worth for purposes of the USD 2,000,000 threshold. Second, it must be a US domestic trust. If it were a foreign trust, then upon expatriation of the

\[79. \text{IRC s 7701(b)(1)(A)(i)}\]
\[80. \text{Treas Reg s 20.0-1(b), 25.2501-1(b). For the income-tax definition of residency, see IRC s7701(b).}\]

79. IRC s 7701(b)(1)(A)(i).
80. Treas Reg ss 20.0-1(b), 25.2501-1(b). For the income-tax definition of residency, see IRC s7701(b).
settlor, US law would impose a separate, pre-existing mark-to-market tax on assets transferred to a foreign trust by a US person.84 Third, it must be a ‘completed gift’ for US transfer tax purposes.85 Under the completed gift analysis, the transferor must not have retained rights and interests that amount to continued ‘dominion and control’ over the assets.86 An ‘incomplete’ transfer would be sufficient to keep the assets in the net worth calculation.87 Furthermore, the trust must be settled in a State of the United States, which has repealed the US rule against self-settled spendthrift trusts.88 The ability of the settlor’s creditors under local law to reach the trust’s assets would render the transfer to the trust ‘incomplete’.89

If the settlor of the Expatriation Trust is a US citizen, then non-taxable transfers to it will be limited to the lifetime exemption of USD 5,120,000. But if the settlor is the long-term resident of the United States, then a slightly different Expatriation Trust can be employed so that the Green Card holder can transfer an unlimited amount of wealth to the trust while still a domiciliary of the United States In this regard, it is paramount that the transfer to the trust be initially deemed ‘incomplete’ for US gift tax purposes. In the overall scheme of the Expatriation Trust, the best means to render the gift incomplete is for the settlor to reserve a power to appoint trust assets to the settlor’s descendants. IRS regulations deem such a limited power of appointment to constitute sufficient dominion and control so as to cause the transfer to be non-taxable at that time.90 Because the resident is making an incomplete gift to the trust, the 35 per cent gift tax is not imposed.

The funding of the Expatriation Trust by the long-term resident is only the beginning of the strategy, however. Without giving up the Green Card, the expatriate-to-be then vacates the United States so as to cause him or her, under the distinct definition of residency for US transfer tax purposes, to be no longer domiciled in the States. As a non-resident for transfer tax purposes (although still a resident under the US income tax law), the person then renounces the reserved limited power of appointment. Although such a release by a US citizen or resident would cause the initially incomplete gift to become complete at that moment, with the resultant imposition of gift tax, the status of the Green Card holder as a non-resident for US transfer tax purposes at that time takes the person outside of the regime. The only possible assets that would still be includible in the gift tax base would be real property situated in the United States or tangible personal property so situated.91 Neither of them would be a likely trust asset. Of course, the effect of the release of the power of appointment under the gift and inheritance tax regime of the host country must be examined by local advisors. It is the author’s understanding that such releases will not likely be a taxable event in civil-law countries that do not recognize a power of appointment.

After releasing the power of appointment, and preferably after the passage of a considerable period of time, the Green Card holder expatriates. The person’s net worth is below USD 2,000,000 at that time and, assuming tax compliance and a lack of very high past US income tax liability, he or she is not a covered expatriate. The person’s advisor prepares a US

84. IRC s 684(c); Treas Reg s 1.684-2(e). The result would be even worse than under the mark-to-market exit tax on inherent gains under IRC s 877A, because while that section allows offsetting deemed losses and provides for a USD 651,000 exemption against gain, s 684 does neither.
85. Notice 97-19, s III.
86. Treas Reg s 25.2512-2.
87. Notice 97-19, s III.
88. The most reliable states in this regard are Delaware, Alaska, and South Dakota.
90. Treas Reg s 25.2512-2. See also IRS Chief Counsel Advice No. 201208026, 24 Feb 2012. In order for the trust to be considered a non-grantor trust, the limited power must be in a non-fiduciary power and must be limited to making distributions of corpus based on the health, education, maintenance and support needs of the beneficiary. IRC s 674(b)(5)(A). Furthermore, in order to prevent grantor trust status, the terms of the Expatriation Trust must provide that no income or principal can be distributable to the settlor without the consent of an adverse party. IRC s 677.
91. IRC s 2103; Treas Reg s 20.2104-1(a).
Expatriation Tax Return showing that the person is not a covered expatriate. ⁹²

**To remove assets from the mark-to-market tax regime**

If classification of the person as a covered expatriate is inevitable, then the advisor can employ the Expatriation Trust to remove assets from the net which draws assets into the mark-to-market tax scheme. This net catches assets in a trust that would be includible in the covered expatriate’s estate for US transfer tax purposes, as if the expatriate died as a citizen or a resident of the United States on the day before expatriation. ⁹³ A properly crafted Expatriation Trust will avoid inclusion.

An advisor of an expatriating US citizen will structure the trust to be a completed gift and will recommend funding it up to the taxpayer’s remaining USD 5,120,000 exemption. In this case, the taxpayer should transfer assets to the Expatriation Trust that houses the greatest unrealized gain. Although the trust may not serve to remove all assets from the mark-to-market tax base, it nevertheless sequesters the assets with the greatest potential for taxation of inherent gains.

For the expatriating long-term resident who is transferring an amount over the USD 5,120,000, the advisor will cause the transfer (or such part of the transfer) to the trust to be initially incomplete for US gift tax purposes through reservation of the limited power of appointment and, after the person has established residency abroad, advise renunciation of the power. After these steps have been accomplished, the citizen or long-term resident may officially expatriate and avoid the mark-to-market tax on the trust assets. ⁹⁴ As discussed above, the completion of the transfer while the Green Card holder is no longer domiciled in the States will cause exclusion from in the tax base.

In the case of both the citizen and the long-term resident who set up an Expatriation Trust to remove assets from the mark-to-market tax base, and in contrast to the Expatriation Trust used for reducing net worth below the USD 2,000,000 threshold, the trust should be a ‘grantor trust’ for US income tax purposes. Why? First, the status of a trust as ‘grantor’ does not automatically cause inclusion in the mark-to-market tax base, unlike the inclusion of grantor trust assets in the net worth analysis. ⁹⁵ Second, if a covered expatriate receives a distribution at any time after expatriation from a non-grantor trust that was not included in the mark-to-market tax base, there is a 20 per cent withholding tax, as discussed above under the heading ‘tax on distributions from non-grantor trusts’. Such is not the case with a distribution from a grantor trust. Although it is the case under US tax law that, except in limited circumstances not applicable here, a foreign person cannot be considered to ‘own’ a trust for US income tax purposes (ie it cannot be a ‘grantor trust’), and indeed the person will become a foreigner upon expatriation and thus render the trust ‘non-grantor’, the exit tax regime imposes the tax on distributions from only trusts that were non-grantor ‘immediately before the expatriation date’. ⁹⁶ Because the covered expatriate becomes a foreign person upon expatriation and not ‘immediately before’, subsequent distributions from the Expatriation Trust to the expatriate will not be subject to the

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⁹². This is accomplished on IRS Form 8854—Initial and Annual Expatriation Statement. Because the expatriate under the new post 16 June 2008 regime does not have any subsequent filing obligations as an expatriate, there will be no ‘annual’ statement for ten years thereafter, as under the previous regime. Instead, the expatriate will be left with the possibility of reporting US-source income on Form 1040NR, like any other ‘nonresident alien’ of the United States.

⁹³. Notice 2009-85, Section 3.A.

⁹⁴. See note 81 for a discussion of use of the Green Card as a means of re-entry to the States and of US immigration law considerations. Most notably, if loss of permanent residency status is deemed to have occurred before the renunciation of the power (ie completion of the gift), the Expatriation Trust assets will be included in the mark-to-market tax base.

⁹⁵. Notice 2009-85, in an introductory section, would seem to include grantor trust assets as property under the mark-to-market tax, but in the section of the Notice dealing specifically with property, it does not automatically include such assets. Instead subjects such trusts to the estate tax inclusion analysis and the beneficial interest analysis. See Sections 1 (‘Introduction’) and 3.A (‘Mark-to-Market Regime: Identification of a covered expatriate’s property and determination of fair market value’) of Notice 2009-85.

⁹⁶. IRC § 877A(f)(3).
withholding tax on distributions from non-grantor trusts.\textsuperscript{97}

An Expatriation Trust has the further benefit of avoiding the inheritance tax on distributions to US recipients, who perhaps would include a covered expatriate’s children who remained behind or who later returned to the United States. The distributions would not be caught in the inheritance tax scheme because the settlor’s contributions to the trust were made before he or she became a covered expatriate.\textsuperscript{98}

\textbf{Conclusion}

The new US exit tax scheme makes it very painful to break off a long-term relationship with Uncle Sam. But with creative planning, the pain can be legitimately avoided or, in other cases, ameliorated.

\textsuperscript{97} It should be noted that a person’s beneficial interest in a grantor trust may be subject to valuation and thus includible in the mark-to-market tax base. Notice 2011-85, Section 3.A. In applying the valuation principles that the Notice refers to, however (which are found in Notice 97-19), the settlor’s purely discretionary beneficial interest in the Expatriation Trust, as structured in this article, is not subject to valuation.

\textsuperscript{98} IRC § 2801(e).