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Advising the expatriating American: beware the exit tax

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Abstract

The US Foreign Account Tax Compliance Act (FATCA) reporting regime has caused such hardships for its citizens living abroad that they are heading for the exits. The renunciation of citizenship, however, exposes the expatriates to the complicated and often expensive US exit tax. Advisors to these persons need to be aware of the fundamentals of the taxation scheme and encourage their clients to plan before renouncing.

Introduction

In recent years, the number of US nationals renouncing their citizenship has increased significantly.[1] The primary driver of the renunciations is the difficulty that Americans living abroad face in the wake of the US FATCA regulations.[2] This regime burdens citizens holding non-US assets with extensive reporting requirements to the US Internal Revenue Service (IRS) and forces financial institutions with American clients to report to the IRS as well. Many Americans living in Europe, Asia, or elsewhere are hard-pressed to find a bank or investment house that will take them as a customer. The everyday lives of these American have been changed, and they simply no longer perceive any overriding advantage to remaining US citizens. Indeed, renunciation has the further benefit of removing the erstwhile American from Uncle Sam's scheme of taxing citizens, regardless of their country of residence, on all income worldwide.

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A further phenomenon wrought by FATCA is that persons who have hardly if ever set foot in the USA are discovering that they are indeed American citizens.[3] FATCA forces banks to inquire into which of its customers are citizens and in many cases report them directly or indirectly to the IRS. An affirmative answer to questions such as 'Where you born on American soil?',[4] 'Is your father or mother American?',[5] 'Is any

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1. The US Treasury Department reported 3415 expatriations in 2014 and 2999 in 2013. In the first quarter of 2015, there were 1335. Since beginning to compile statistics in 1998, there had been only two years in which expatriations topped 1000.

2. RW Wood, 'Americans Renouncing Citizenship Up 221%, all Aboard the FATCA Express' *Forbes* (New York, 6 February 2014); L Pleven and L Saunders, 'Expatriate Americans Break Up With Uncle Sam to Escape Tax Rules' *Wall Street Journal* (New York, 16 June 2014) and 'Overseas Americans: Time to Say 'Bye' to Uncle Sam?' *Wall Street Journal* (New York, 17 August 2013).

3. C Panozzo, 'When American Expats Don't Want Their Kids to Have U.S. Citizenship' *Wall Street Journal* (New York, 18 February 2015).

4. Under the 14th Amendment and 8 US Code s 1401(a), all persons 'born in the United States, and subject to the jurisdiction thereof' are American citizens at birth. This occurs by operation of law, regardless of the intention of the parents or child. There is no requirement that the parents have any prior residence or physical presence in the USA (United States Code is hereafter 'USC').

5. For the past 70 years, a person born abroad to two American-citizen parents is an American citizen at birth, if one of the parents 'had a residence in the United States or one of its outlying possessions, prior to the birth of such person.' 8 USC s 1401(c). There is no minimum period of residence required. Since amendments to US law effective 14 November 1986, a person born abroad to only one American-citizen parent is an American citizen at birth, if the American-citizen parent 'prior to the birth of such person, was physically present in the United States or its outlying possessions for a period or periods totaling not less than five years, at least two of which were after attaining the age of fourteen years' 8 USC s 1401(g).

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grandparent American?'[6] may find the customer in the net of the IRS or without a bank, or both. These accidental Americans also want out.

But there is a price to expatriation. The country that once welcomed immigrants with open arms now slaps its citizens with a toll when they choose to leave.[7] The toll is the exit tax, and when it applies, it can be very expensive. This article proceeds to briefly describe the exit tax and then suggest ways to legitimately avoid or at least minimize it.

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The exit tax

The exit tax consists of primarily three distinct taxes. First, the value of one's pension or retirement scheme is taxable either immediately upon expatriation or on a deferred basis.[8] Secondly, if the expatriate is a beneficiary of a 'nongrantor' trust, distributions to the expat beneficiary will be subject to a withholding tax on such portion of the distribution as represents ordinary trust income.[9] Thirdly, all asset wherever located and not covered by the previous categories are subjected to a mark-to-market tax on unrealized gains, as if the expatriate had sold all such property.[10] Rates of tax under the three categories range from about 20–40 per cent.[11] The mark-to-market segment exempts the first USD690,000 of deemed gain from tax.[12]

The payment of the exit tax, however, does not end exposure to the scheme. To the extent that the expatriate makes later transfers of assets to US citizens or residents, either during life or at death, the recipient must pay an inheritance tax of 40 per cent.[13]

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In order for the exit tax and the inheritance tax to apply, the expatriating American must meet any one of three tests.[14] If a test is met, the person is deemed a 'covered expatriate'. The first is a net worth of USD2,000,000 or more.[15] The base of assets in the net worth analysis is quite broad. For example, the base includes worldwide assets, fractional interests in property, and business, investment and personal use assets.[16] No category is exempted. And, if the expatriate is a beneficiary of a trust, even a totally discretionary vehicle, the IRS says that the beneficial interest must be somehow valued and included in the base.[17] The second test concerns the person's US income tax liability over the previous five years.[18] If

6. If the grandparent's citizenship cause the next generation (the 'parent' in this example) to be an accidental American, then that American's own child (the bank's hypothetical client) could be another accidental American.

7. The exit tax is also imposed on certain long-term permanent residents of the US Internal Revenue Code, Title 26 USC s 877A(g)(1). The Internal Revenue Code is hereafter 'IRC'.

8. IRC s 877A(c)(1),(2).

9. ibid s 877A(c)(3). A 'nongrantor' trust is one that the person is not considered to 'own' for US income tax purposes. IRC ss 671–8. There is no treaty relief available to reduce the tax rate below 30 per cent. IRC s 877A(f)(4)(B).

10. ibid s 877A(a)(1).

11. ibid ss 1, 1411.

12. ibid s 877A(a)(3); US IRS Revenue Procedure (Rev Proc) 2014-61, 2014-47 Internal Revenue Bulletin (IRB) 860 (30 October 2014).

13. IRC s 2801.

14. ibid ss 877A(g)(1), 877(a)(2).

15. ibid s 877(a)(2)(B).

16. IRS Notice 97-19, s III, 1997-1 Cumulative Bulletin (CB) 394 (24 February 1997) (hereafter 'Notice 97-19').

17. ibid.

18. IRC s 877(a)(2)(A).

the average tax liability is USD160,000 or more, then the person is a covered expatriate.[19] The final test is one of compliance. The person must be fully compliant with the US Internal Revenue Code over the previous five tax years and must certify this fact.[20] Compliance includes not only payment of all taxes but informational reporting such as that required under FATCA and under the reporting rules for beneficiaries of foreign trusts.[21]

Avoidance or minimization

Regardless of the size of their net worth or income tax liability, some lucky expatriates will be able to avoid the exit tax entirely by fitting into a statutory exception. Others may be able to engage in planning that will serve to either avoid classification as a 'covered expatriate' or at least minimize the tax.

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Fitting into an exception

There are two exceptions that may benefit US citizens who otherwise may be deemed to be covered expatriates. The first concerns dual nationals, and the other deals with minors.

A person who at birth becomes a citizen of the USA and another country, and who is taxed as a resident of the other country at the time of expatriation, may be exempted from the tax.[22] To qualify, the person must not be considered a US 'resident' under the tests applicable to non-citizens for more than 10 of the last 15 tax years.[23] The residence test counts the number of days in the subject tax year and the two previous tax years in which the person was physically present in the States and then subjects the numbers to a formula.[24]

Minors have an exception of their own. If a US citizen renounces before age eighteen and a half, then the person may avoid covered expatriate status if he or she has not met the residence test for more than 10 years.[25]

In the case of either the dual-nationals or minors exception, the person must still meet the tax compliance prong of the covered expatriate test.[26] In other words, the exceptions only apply to give relief under the net worth and tax liability prongs. Compliance is always required.

Avoiding classification as a covered expatriate

In most cases an exception will not apply, but the person can nevertheless engage in some pre-expatriation planning so as to possibly avoid classification as a covered expatriate. If the person has had one or more extraordinary earning years, he or she can wait until the five-year tax liability average falls below the USD160,000 threshold. If net worth is above USD2,000,000, the person can use all or part of his or her US gift tax exclusion amount of USD5,430,000 to give away assets and thus reduce net worth below the threshold.[27] A beneficial interest in a trust that is otherwise countable in net worth can be disclaimed, but the act of disclaimer may itself be a gift and thus would use up exclusion.[28] It is important to note that when a gift is contemplated, the gift tax

19. ibid. The amount is adjusted for inflation. USD690,000 is the figure for expatriations taking place in 2015. Rev Proc 2014-61, above.
20. IRC s 877(a)(2)(C).
21. ibid.
22. ibid s 877A(g)(1)(B)(i).
23. ibid.
24. ibid s 7701(b)(1)(A)(ii). As a general rule, 121 or fewer days of physical presence in each of the three consecutive years will not trigger residency status.
25. ibid s 877A(g)(1)(B)(ii).
26. ibid s 877A(g)(1)(B).
27. As a US citizen, regardless of residency, the person is subject to the US gift tax. As such, the person is benefited by the exclusion amount, which is adjusted annually for inflation. IRC ss 2501, 2511, 2505. The 2015 figure is USD5,430,000. Rev Proc 2014-61 above.
28. IRC s 2518.

laws of the person's country of residence or other citizenship must be taken into account. Although several European countries impose a gift tax, many other countries do not.

If the person's net worth is so substantial that making gifts of USD5,430,000 will not serve to place the person below the USD2,000,000 threshold, then there are legitimate avenues under US tax law for packaging assets into company structures and making gifts of fractionalized interests. Because these interests have a value to the recipient that is less than the proportionate underlying asset value, the person has effectively discounted the valuation. Discounts of 30–40 per cent are not unusual. This type of structuring takes careful planning and implementation and requires in-depth valuation reports by high-calibre experts. There are other advanced US estate planning techniques that may serve the would-be covered expatriate well.

Because the person may not want to fully part with wealth so as to avoid covered expatriate status, certain trust structures are available under the laws of some states of the USA that may give the person comfort while still serving to remove the assets from the net worth calculation. For example, under Ohio law, the person can create a trust (settlement) and transfer assets to it, reserving no powers or beneficial interests (save perhaps the power to remove and replace the trustee with an independent party or to substitute trust assets with personal assets of like value), and granting to a third party the power to appoint trust assets back to the settlor. By Ohio statute, creditors of the settlor cannot reach the trust assets in satisfaction of their claim unless and until the power-holder in fact appoints assets back to the settlor.[29] Because of the inability of creditors to reach the assets, the IRS ignore the settlement in calculating the value of settlor's assets.[30] As a result, the assets in this 'Ohio power-of-appointment trust' will not be included in the net worth base. And because the settlor did not remain as a trust beneficiary, the IRS cannot use its other mechanism of attempting to value and include beneficial interests in the net worth calculation.[31] The settlor simply did not retain a beneficial interest.[32]

When planning with trusts to avoid covered expatriate status, it is usually preferable that the structure classifies as a domestic trust under US law. The use of a foreign trust may have unintended results beyond the exit tax. In short, either upon formation of the foreign trust or at expatriation (when the trust likely becomes a foreign trust), a mark-to-market tax that is separate from the exit tax will be imposed on unrealized gain in the assets, but in contrast to the exemption of USD690,000 of gain under the exit tax scheme, this other taxation pitfall offers no exemption.[33]

Although successful planning to avoid covered expatriate status will produce the ultimate result, namely no exit tax imposed on the expatriating citizen and no inheritance tax charged to the person's US heirs, covered expatriate status will be inevitable in some cases. For example, if the value of the expatriate's pension and other retirement schemes exceeds USD2,000,000, planning options are typically not available to reduce net worth below the threshold. Retirement schemes are usually not assignable, so they cannot be gifted to other persons or to a trust.

The remainder of the planning points in this article assumes that covered expatriate cannot be avoided.

29. Ohio Revised Code s 5805.06(B)(3)(b). The only other US state that has such a statute is Arizona.

30. See generally, *Estate of German*, 7 Ct Cl 641 (Ct Cl, 1985); IRS Revenue Ruling (Rev Rul) 76-103, 1976-1 CB 293; Rev Rul 77-378, 1977-2 CB 347; Rev Rul 2004-64, 2004-2 CB 7. If, however, the IRS suspects from analysis of all the facts that there was a pre-existing arrangement between the settlor and the power-holder to appoint assets back to the settlor, the Service will attempt to include the trust assets in the net worth base. It is fundamental that there be no such arrangement or understanding. Furthermore, the power-holder should allow the structure to ripen before even considering an exercise of the power.

31. See text accompanying n 17.

32. There are 16 states of the USA that allow for a settlor to create a trust in a non-fraudulent manner and remain as a beneficiary, while keeping most types of creditors at bay. This structure can work to keep the entirety of the trust assets out of the net worth base, but the IRS will still attempt to value the beneficial interest, even if it is a purely discretionary interest. Notice 97-19, s III.

33. IRC s 684.

Minimizing the tax as a covered expatriate

If covered expatriate status is inevitable, then pre-expatriation planning may serve to minimize or defer the tax.

First, the expatriate may retain assets that carry an unrealized gain approximating the USD690,000 exemption from the mark-to-market tax. If retained assets include a US vacation property or prior homestead, and the expatriate plans to sell the immovable at some point, a tax basis adjustment that accompanies allocation of the gain exemption to retained assets can be used very effectively.[34] After renouncing citizenship, the covered expatriate will still be liable for capital gains tax on US-sitused immovables,[35] but the tax basis in the US property will receive a basis adjustment that reflects its proportionate share of the gain exemption, as allocated among all property subjected to the mark-to-market tax based on the unrealized gain attributable to each asset.[36] As a result, what would otherwise have been a taxable gain on sale will be tax free, wholly or in part.

Secondly, the person can still make use of the USD5,430,000 gift tax exclusion amount to take assets beyond the reach of the mark-to-market tax. If recipients of these gifts are individuals who are neither US citizens nor residents, then they will not pay US capital gains tax on the later sale of the assets, with the limited exceptions noted above.

If the expatriate is uncomfortable with giving away assets outright, the person can employ the Ohio power-of-appointment trust or a self-settled spendthrift trust in a state of the USA that recognizes such structures, such as Ohio.[37] The unrealized gain trapped in the assets that are transferred to the trust will not be taxed until sale by the trustee.[38] To the extent, however, that appreciated assets are distributed back to the expatriate by the trustee or at the direction of the holder of the power of appointment, there is no US capital gains tax on the distribution of the appreciated assets.[39] And because the expatriate has renounced citizenship and enjoys the status of a 'nonresident alien' under US income tax law, the person will not incur a US capital gains charge upon later sale of the assets, save under the limited exceptions noted above.

To the extent that trusts are used, it is important that the planner structure the trust to be 'grantor' for US income tax purposes. There are various reserved powers that can be used to accomplish this purpose without causing the transfer to run afoul of the separate US gift and estate tax rules that apply to the transfer.[40] Although the grantor trust will become 'nongrantor' as of the date of expatriation,[41] the separate exit tax component that applies to a 30 per cent withholding tax on distributions from certain trusts to a covered expatriate covers only 'nongrantor' trusts as that status is determined on *the day before* the expatriation date. As of the day before, the trust is still a grantor trust. Thus, distributions from the trust to the expatriate will not incur the 30 per cent withholding tax.[42]

Aside from the exit tax applicable to the renouncing citizen, the covered expatriate's heirs will be subject

34. If the expatriate, instead of selling the US immovables during life, dies holding it or makes a gift of it during life, the property will be chargeable under the US estate or gift tax. IRC ss 2101 and the following. ss 2501 and the following . An applicable inheritance tax treaty may provide relief, however. If the recipient of a bequest or gift from the covered expatriate is a US citizen or resident, the inheritance tax under IRC s 2801 will not be chargeable (and thus there will be no double tax). IRC s 2801(e)(2).

35. The tax would also be due on the sale of assets effectively connected with the operations of a US business. IRC ss 871, 897.

36. IRS Notice 2009-85, s 3.B, 2009-45 IRB 598 (15 October 2009).

37. The trust will be structured to be a 'completed gift' for US transfer tax purposes.

38. As a domestic 'nongrantor' trust, the trust is a resident US taxpayer.

39. IRC s 643(e). The distribution may carry with it, however, a part of the trust's US-derived dividend income, which would be taxable to the nonresident alien distributee. Treaty relief may be available to reduce the 30 per cent tax rate on the dividend income.

40. The most popularly used power is the ability of the settlor, acting in a non-fiduciary capacity, to substitute personal assets for trust assets of equivalent value. IRC s 675(4). This power triggers grantor trust status but does not render the gift to the trust 'incomplete' for US transfer tax purposes. An incomplete gift would subject the trust assets to the mark-to-market tax.

41. IRC s 672(f).

42. See text accompanying n 9.

to the inheritance tax if they are US citizens or residents at the time of the *inter vivos* gift or testamentary bequest by the expatriate.[43] In this regard, the IRS will credit any foreign inheritance tax paid, and further relief may be available under an applicable inheritance tax treaty.[44]

Conclusion

The US exit tax imposed on expatriating citizens will be very expensive for some, but careful planning can serve to either legitimately avoid the tax or minimize its impact.

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43. See text accompanying n 13.
44. IRC s 2801(d); see MJ Stegman and JL Campbell, 'Confronting the New Expatriation Tax: Advice for the U.S. Green Card Holder' (2009) 35(3) Journal of the American College of Trust & Estate Counsel.