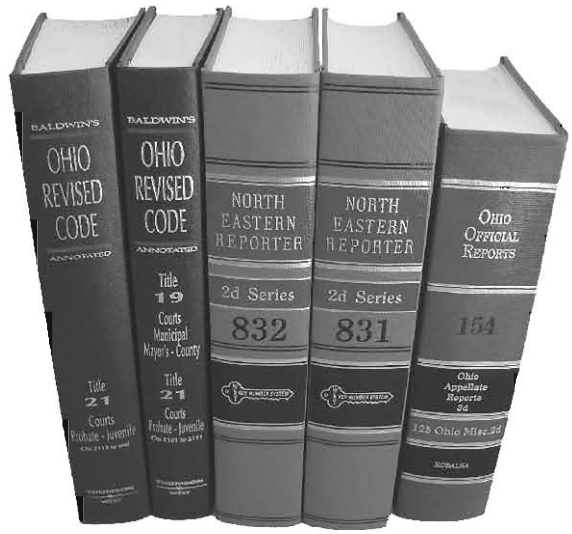

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IN THIS ISSUE

Breaking Up Is Harder to Do: The New Alternative Tax Regime on U.S. Expatriates

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In the 2008 HEART Act,[1] Congress enacted an entirely new set of tax laws that affect certain citizens who renounce citizenship and long-term residents who depart the U.S. For the first time, we have both an "exit tax" applicable to these individuals and an inheritance tax on later transfers from these persons. Rather than the relatively rare case of the individual who renounces U.S. citizenship, these taxes will more likely ensnare the international executive who has resided in the States for an extended period and then is reassigned to another country. Indeed, as shall be explained later in this article, the new tax regime can even cause an inadvertent cessation of long-term residency and a deemed "expatriation" that triggers the taxes.

The new law is effective for expatriations occurring on or after June 17, 2008. Before exploring the new law, we would do well to review the "alternative tax regime" that was previously in place and that still applies to expatriations before such date.

The Former Alternative Tax Regime

Since 1966, there has been some sort of alternative tax regime for expatriating citizens. Congress believes that Americans who renounce citizenship for tax avoidance purposes should pay more tax—income, estate and gift tax—than the typical nonresident-noncitizen of the U.S. The typical, nonexpatriate foreigner who is not a U.S. resident pays (a) income tax on U.S.-source dividends, rents and certain other items at a 30% rate (unless the rate is reduced by a treaty)[2]; (b) gift tax on the gratuitous transfer of U.S.-sited real property and tangible personal property[3]; and (c) estate tax on U.S.-sited real property and tangible personal property (again) and also on, primarily, stock in domestic corporations.[4]

For the expatriate, however, the items of income or property subject to these taxes were expanded, and the period during which the expatriate would be subject to them was set at ten years after the date of expatriation.[5] Thereafter, the expatriate is taxed like any other foreigner who is not a U.S. resident.

In 1996, Congress came to believe that foreigners who live in the States long enough and then go back home or move elsewhere deserve the same treatment as the expatriating citizen.[6] These persons will be referred to as "former long-term residents".[7]

This alternative tax regime remained in place until June 17, 2008. And, for persons who renounced citizenship or who ceased to be long-term residents before that date, it will continue to be effective for them for a period of ten years.

The New Alternative Tax Regime

The new law brings in a very different alternative tax regime. It imposes taxes of an entirely new ilk—a "mark-to-market" income tax on "deemed" gains, for example, and a transfer tax on gifts and bequests which is in fact an inheritance tax charged to the recipient. Central to the new regime is the concept of the "covered expatriate".

The Covered Expatriate

A person who comes under the new regime is referred to in the statute as a "covered expatriate". There are two criteria that must be met before the person can be deemed a covered expat.

First, the person must be a U.S. citizen who renounces citizenship (with certain narrow exceptions for minors and dual citizens) or a "long-term resident" who ceases to be treated as such.[8] To be considered a long-term resident, the foreigner must first have been a "lawful permanent resident" of the U.S., that is, a Green Card holder,[9] for any part of eight of the previous 15 years.[10] This is known as the 8-of-15 Rule. A key consideration of the 8-of-15 Rule is that holding a Green Card for just one day within a calendar year counts as a year.[11] In other words, the international executive need not have been a lawful permanent resident for 8 full years in order to qualify. It could be, for example, just 6 full years with a part of a calendar year on either side. A Green Card holder who meets the 8-of-15 Rule is considered a "long-term resident". The person is then treated as an expatriate when he or she turns in the Green Card, has it taken away through an administrative or judicial proceeding or, as we will be explained later in this article, when he or she takes up residence in a county with which the U.S. has a tax treaty and subsequently claims the benefits of that treaty.[12]

The second criterion for being considered a "covered expatriate" looks at the person's asset or income level and the person's previous compliance with U.S. tax law. Under this criterion, there are three alternative ways for the person to qualify:

First, the person's average annual net income tax (not net income itself, but the tax) for the preceding five tax years exceeds a certain inflation-adjusted threshold.[13] For expatriations in 2008, it was an average of $139,000 of tax over five years.[14] For expatriations in 2009, it is an average of $145,000.[15]

Second, the person has a net worth of $2,000,000 or more, considering all assets worldwide.[16] This figure is not indexed for inflation.

Third, regardless of income tax liability or net worth, the person is considered a covered expat if he or she fails to certify full compliance with all U.S. internal revenue laws for the preceding five years.[17]

A covered expatriate will have to face taxes that fall into two broad categories, the income taxes under new Code Section 877A and transfer taxes found in new Section 2801.

The Income Taxes (Exit Tax)

The income taxes themselves come in four varieties. These are collectively known as the "exit tax". Most of them are draconian.

The "Mark-To-Market" Tax

The first income tax is called the "mark-to-market" tax. It is a tax on deemed gains, not actual gains. On the day before the expatriation date, the taxpayer is considered to have sold nearly all of his or her worldwide assets, with certain exceptions discussed below.[18] For the purposes of determining gain, each asset is "marked to the market", that is, it is assigned a value equal to the fair market value as of that day. The normal basis rules apply, except that, in the case of the former long-term resident, the basis of each asset that the taxpayer held upon becoming a U.S. resident is equal to at least its fair market value as of that date (unless the taxpayer elects otherwise).[19]

To the extent that the deemed gain exceeds an exclusion amount, it is taxed at normal rates. For expatriations in 2008, the exclusion was $600,000.[20] The exclusion is adjusted for inflation. For 2009, it is $626,000.[21]

The second, third and fourth income taxes are on certain assets and distributions that are exceptions to the mark-to-market tax.

Specified Tax Deferred Accounts

The second income tax is on Specified Tax Deferred Accounts. These are primarily individual retirement accounts, Section 529 plans, health savings accounts, Archer medical savings accounts, and Coverdell education savings account. For these assets, the covered expatriate is deemed to have received a distribution of the entire account as of the day before the expatriation date. Income tax will be due at ordinary rates. There is no exemption amount.[22]

If the taxpayer needs to take a distribution from an IRA in order to pay the tax, the question arises as to whether an early distribution penalty would apply in the case of a distribution occurring before age 59 ½. The statute isn't clear. It affirms that the treatment of the account as having been fully distributed will not invoke the penalty, but it is silent as to an actual distribution.[23]

Deferred Compensation Items

The third income tax is on Deferred Compensation Items. These primarily include qualified plans, tax-sheltered annuities, government plans, SEPs and SIMPLEs.[24] If the Deferred Compensation Item is "eligible", as defined in the statute, the tax isn't nearly as onerous as the mark-to-market tax or the tax on IRA's and other Specified Tax Deferred Accounts. For the eligible account, there is no immediate tax. Instead, the administrator withholds 30% of the taxable portion of each subsequent distribution (usually the entire distribution is taxable).[25] The covered expat then pays tax as a typical nonresident, noncitizen would on such distributions.[26]

An item is eligible if two criteria are met. First, the plan administrator or trustee must meet the statutory definition of "United States Person".[27] In this context, a U.S. Person means a domestic bank, trust company or corporation.[28] Second, the taxpayer must notify the trustee or provider that he or she is a covered expatriate and irrevocably elect to waive any tax treaty provision that would provide for a lower rate of withholding.[29]

It appears that Congress eased up when it came to these pension arrangements under the control of a U.S. trustee or administrator. And that statute provides a workable mechanism for the trustee or provider, in that they receive a notice telling them that the recipient is indeed a covered expatriate.

If the account is ineligible, however, the result is similar to that with the tax on Specified Tax Deferred Accounts: the expat is in most cases deemed to have received a distribution on the day before the expatriation date equal to the present value of the accrued benefit.[30]

Distributions from Nongrantor Trusts

The fourth income tax has to do with distributions from nongrantor trusts in which the covered expatriate is a beneficiary.[31] A distribution from a trust involves a "taxable portion," that which would normally be taxable to a beneficiary under tax accounting principles.[32] The trustee must withhold 30% of the taxable portion,[33] and the expatriate pays tax as a typical nonresident, noncitizen would.[34]

If the distribution is wholly or partly in-kind, the tax result becomes more complex. In this case, the property is deemed to have been sold by the trust to the beneficiary at its fair market value. To the extent that there is deemed gain, the trust pays the tax on the gain at the normal rates applicable to trusts.[35]

IRS Form W-8CE is used to advise the trustee that the beneficiary is a coverd expatriate.

Besides these income taxes, there are transfer taxes akin to estate and gift taxes.

The Transfer Taxes

The transfer taxes come into play when a covered expatriate makes a gratuitous transfer, during life or at death, to an individual who is a U.S. citizen or resident or to certain trusts.[36] Under Subtitle B—Estate & Gift Taxes—of the Internal Revenue Code, there is a new Chapter 15 called Gifts and Bequests from Expatriates. The sole Code section within Chapter 15 is new Section 2801.

If an individual who is a U.S. citizen or resident receives an inter vivos gift or testamentary bequest from a covered expatriate, the individual recipient pays a tax on the value of the property at the highest rate then applicable under the Code under its estate tax and gift tax regimes, currently 45%.[37] There is an exemption equal to only the annual exclusion, which is currently $13,000.[38]

With the advent of this levy, we now have a true inheritance tax under the Internal Revenue Code. Although practitioners in many foreign countries and a few U.S. states are familiar with this, it will be new to others. The recipient will be responsible for filing the return and paying the tax. The IRS is developing a new form, the 708, to be called the U.S. Return of Tax for Gifts and Bequests Received from Expatriates.[39]

There is no time limitation after which the gratuitous transfers from the covered expatriate will not be taxed. If the gift or bequest falls within the statutory scheme, it will reach gifts during the entire remaining life of the covered expat and bequests at death. And it does not matter whether the transferred assets are U.S.-sited.

New Section 2801 also captures transfers from a covered expatriate to certain trusts.[40] In this regard, a distinction must be made between domestic trusts and foreign trusts.

A "domestic trust" is a trust to which both of the following apply: a U.S. federal or state court is able to exercise primary jurisdiction over the administration of the trust, and a U.S. Person (generally a U.S. citizen or resident or a U.S. domestic corporation) has the authority to control all substantial trust decisions (presumably as a trustee and without substantial decisions being made by a non-U.S. trust protector or other party).[41] A foreign trust is any other trust.[42]

If a covered expatriate makes a gift or bequest to a domestic trust, the trust pays the Section 2801 tax.[43] It does not matter whether one or more of the beneficiaries of the trust is a U.S. citizen or resident. The status of the trust as domestic is enough. If a covered expatriate makes a transfer to such a trust, the trustee will owe the tax. This puts the burden on the trustee of determining whether the donor or decedent is indeed a covered expat.

In the case where a foreign trust receives the gift or bequest, the trust itself is not the taxpayer. Instead, upon a subsequent distribution that is wholly or partly attributable to the receipt, the beneficiary pays the tax.[44] In this case, the beneficiary must be a U.S. citizen or resident.[45] The IRS needs to develop rules for attributing a receipt from a covered expat to a subsequent distribution.

If all or a portion of the distribution from the foreign trust is includable in the income of the individual under the principles associated with U.S. income taxation of distributions from foreign trusts, then the individual receives an income tax deduction under IRC § 164 for the transfer tax imposed by §2801 on such part of the distribution that is so includable in income.[46]

In all cases with the Section 2801 tax, if there is a foreign gift, estate or inheritance tax due on the transfer, the U.S. gives a full credit against its tax.[47] And if the U.S. would tax the transfer under its normal rules not involving the alternative tax regime, then the Section 2801 tax is not imposed.[48] For example, if the gift or bequest involves U.S.-sited real estate, then the typical gift or estate tax imposed on a nonresident-noncitizen would apply instead.[49] This may be beneficial to the expat, because in the case of the estate tax applicable to nonresident-noncitizens, there is a $60,000 exemption.[50]

Expatriation Date

Under the new alternative tax regime, it is important to precisely determine the expatriation date. For purposes of the Section 2801 transfer tax, it marks the date on or after which a gift or bequest from a covered expatriate is taxable. And, for some of the income taxes, it marks the valuation date. For example, the mark-to-market tax requires valuation of all assets as of the day before the expatriation date for purposes of calculating the tax on deemed gains.

In determining the expatriation date, citizens and lawful permanent residents are considered separately.

For citizens, the date can be determined fairly easily. For example, it is the date on which the citizen appears before a diplomatic or consular officer and affirmatively renounces citizenship or files a voluntary relinquishment of citizenship with the State Department.[51] In both cases, the Department will later issue a certificate of loss of nationality which contains the renunciation date and therefore the expatriation date.[52]

For lawful permanent residents, the expatriation date can be determined with certainty in three instances, but there is a fourth that is troublesome. The three easy ones are the voluntarily relinquishment by the resident of his or her Green Card, the determination through a U.S. administrative procedure that the resident has abandoned lawful permanent residency, or the deportation or exclusion of the resident through administrative or judicial proceedings.[53]

The fourth instance does not only cause an uncertain expatriation date, but in perhaps the harshest result of the new regime, will often result in an unintended cessation of long-term residency and a consequent exit tax. It will potentially ensnare the Green Card holder who departs the U.S. and takes up residency in a country with which the U.S. has a tax treaty. Given that the U.S. has income tax treaties with over 60 nations, it will likely be the case that the person ends up in one of these.

In this instance, expatriation will be fixed as of 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, does not waive the benefits of such treaty applicable to residents of the foreign country, and notifies the [U.S. Treasury] Secretary of the commencement of such treatment".[54] This statute seems to have two main operative parts. First, the person must become a resident of a treaty country. Second, the person must not waive the benefits of the treaty, which would be the case if the taxpayer affirmatively takes advantage of a treaty provision on a U.S. income tax return. As a corollary to this second component, the taxpayer notifies the Treasury Secretary of the benefits claim, which again happens when he or she files the return.

As a result of this statute, if a person who otherwise meets the definition of a covered expatriate ends up in a treaty country and takes the seemingly innocent step of filing his or her Form 1040 (as any Green Card holder is required to do as an income tax resident of the U.S., regardless of where they live), and on that return the taxpayer takes a treaty-based position providing tax relief, then the person is deemed to have expatriated for purposes of the new alternative tax regime. The various income taxes may apply (and some of them immediately), and the transfer taxes may subsequently apply. A harsh result indeed.

In this regard, the exact expatriation date remains to be deciphered. Although the IRS has issued no guidance on determining this date, it has released the 2008 version of Form 8854 – Expatriation Information Statement. On this form, there is a blank space where the "long-term resident with dual residency in a treaty country" enters his or her expatriation date. The form reads as follows: "Date commencing to be treated, for tax purposes, as a resident of the treaty country _____".[55] The instructions to the form are not particularly helpful. They provide: "If you were a dual resident of the United States and a country with which the United States has an income tax treaty, the date you commenced to be treated as a resident of that country and you determined that, for purposes of the treaty, you are a resident of the treaty country and gave notice to the Secretary of such treatment on Forms 8833 and 8854."[56] (Form 8833 – Treaty-Based Return Position Disclosure – is required to be attached to any U.S. tax return on which the taxpayer is claiming treaty relief.)

These instructions are picking up on the statutory definition of cessation of long-term residency, which has at its core 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."[57] This commencement date under the treaty should mark the expatriation date. The treaty commencement date would necessarily be the date on which the person commences to be a resident of a treaty country under the internal law of that country. For a taxpayer to be eligible to claim treaty benefits, the treaties provide that the person must first be a resident of that county under its internal law.[58] As such, the law of the treaty country must be consulted.

For example, under the law of France, the taxpayer will find a somewhat vague definition of residency. Under French law, an individual will be deemed to be a tax resident if one of three criteria is met: (1) the person maintains his or her home (understood as the place where the person, spouse and children normally live) or the person maintains his or her principal place of residence in France; (2) the person has his or her professional activity in France; (3) the person has the center of his or her economic interests in France.[59] Any one of these suffices. No definite number of days of presence in France is required under any of them. As this example shows, the taxpayer may not have an objective test for determining the commencement date of residency under the country's internal laws. But if the taxpayer has left the U.S., with spouse and children or other significant persons and with household belongs in tow, and has arrived in a treaty country and has begun making a home there, such date will almost certainly be the relevant expatriation date for tax purposes.

Effect of Tax Treaties

The U.S. internal revenue laws are generally subject to the bilateral treaties between the U.S. and various countries.[60] The treaties affecting taxation are of two primary types, income tax treaties and estate/gift tax treaties. The effect of the numerous income tax treaties is beyond the scope of this article.

The various estate/gift tax treaties, which are currently in force with seventeen countries,[61] concern taxes on gratuitous transfers. With respect to testamentary gratuitous transfers, it is irrelevant whether the tax is denominated as estate or inheritance. Both are subject to the treaty.

The keystone of each treaty is a mechanism for determining which of the two countries has sole or primary taxing right with respect to the transfer. This determination turns on either the situs of the transferred property or the "fiscal domicile" of the transferor. Fiscal domicile under a treaty must be distinguished from domestic law definitions of domicile or residency. Although the treaties first look to the domicile or residency of the taxpayer under the internal law of each country, the treaties provide a tie-breaking mechanism in the event the laws of both countries would treat the person as domiciled there. The tie-breaking rules can differ by treaty.

If the treaty assigns sole taxing rights on a transfer to one country, the other loses its right to tax the transfer under its internal laws. In the case where one country has primary taxing rights on a transfer and the other secondary rights, the treaty requires the other country to give a substantial credit against the taxes it would otherwise impose.

How could an estate/gift tax treaty affect application of the Section 2801 transfer tax? We already know, before consulting any treaty, that the credit for foreign taxes awarded under Section 2801(d) will mean that there will never be double tax. If another jurisdiction taxes the transfer at a rate lower than 45%, then the U.S. will simply make up the difference. But, if we do consult an applicable treaty, can we find further relief? The analysis will be treaty specific. An example may prove helpful.

Assume that the international executive, who is a covered expatriate, had been reassigned to Germany and has been residing there for eleven years since departing the U.S. After receiving a bonus, he or she makes a cash gift to his U.S. resident daughter of €300,000. Assume further that Germany does not tax the transfer because of its inheritance tax exemption of €400,000 applicable to transfers to a child.[62] It would seem at first glance that the U.S. is free to tax the entire €300,000 gift (about US$425,000) at 45%, given that there would be no foreign inheritance tax to credit under Section 2801(d). The terms of the U.S. - Germany Estate and Gift Tax Treaty, however, would come into play. Under the Treaty, the U.S. is precluded from taxing a transfer of this type.[63] Although the Treaty reserves to the U.S. the right to continue to tax individuals who are former citizens or long-term residents, the period for taxation lasts for only ten years.[64] The Treaty was negotiated and concluded while the old alternative tax regime was in place, which called for expanded transfer taxation for a period of ten years after expatriation. The Treaty protected the U.S.'s right to tax under that regime. Under the new regime, there is

no ten year restriction. But the Treaty remains as it is, and it would bar U.S. taxation in this situation.

The outcome would be different if the gifted property were U.S. real estate. Like all other estate/gift treaties, the U.S-Germany Treaty awards primary taking right over real property to the country in which the property is situated.[65] And in this case, the length of time since expatriation would not matter.

In conclusion, the new alternative tax regime may impose harsh and previously unknown taxes on the expatriate citizen or former long-term resident. Advisors to these persons need to be aware of these taxes and devise legal ways to mitigate them.

ENDNOTES

1. Heroes Earnings Assistance and Relief Tax Act of 2008, P.L. 110-245.
2. IRC § 871.
3. IRC §§ 2501, 2511.
4. IRC §§ 2101 *et seq.*
5. IRC §§ 877, 2501(a)(3), 2511(b), 2107(b).
6. Health Insurance Portability and Accountability Act of 1996, P.L. 104-191.
7. IRC § 877(e). "Former long-term resident" is not a statutory term. The Code identifies them as "Any long-term resident of the United States who ceases to be a lawful permanent resident of the United States (within the meaning of section 7701(b)(6)) shall be treated ... as if such resident were a citizen of the United States who lost United States citizenship ..." IRC § 877(e)(1).
8. IRC § 877A(g)(1), (2), (4) & (5).
9. IRC § 7701(b)(6); Treas. Reg. 301.7701(b)-1(b)(3).
10. IRC §§ 877A(g)(5), 877(e)(2). A tax year, however, does not include any year in which the person is treated as a resident of another country pursuant to a treaty with that other country, and the person has not waived the benefits of the treaty that apply to residents of that country. IRC § 877(e)(2).
11. Treas. Reg. 301.7701(b)-1(b)(1).
12. IRC §§877A(g)(3)(B), 7701(b)(6).
13. IRC §§ 877A(g)(1)(A), 877(a)(2)(A).
14. Rev. Proc. 2007-66, 2007-45 IRB 970, 10/18/2007.
15. Rev. Proc. 2008-66, 2008-45 IRB 1107, 10/16/2008.
16. IRC §§ 877A(g)(1)(A), 877(a)(2)(B). IRS Form 8854 – Expatriation Information Statement – includes as "property" the value of all assets held in grantor trusts and the value of all beneficial interests of nongrantor trusts.
17. IRC §§ 877A(g)(1)(A), 877(a)(2)(C).
18. IRC § 877A(a).
19. IRC § 877A(h)(2).
20. IRC § 877A(a)(3).
21. Rev. Proc. 2008-66, 2008-45 IRB 1107, 10/16/2008.
22. IRC § 877A(e).
23. IRC § 877A(e)(1)(B).
24. IRC § 877A(d)(4).
25. IRC § 877A(d)(1).
26. IRC § 877A(d)(6)(B).
27. IRC § 877A(d)(3)(A).
28. IRC § 7701(a)(30).
29. IRC § 877A(d)(3)(B). IRS Form W-8CE is used for this purpose.
30. IRC § 877A(d)(2)(A)(i).
31. IRC § 877A(f).
32. IRC § 877A(f)(2)(b).
33. IRC § 877A(f)(1)(A).
34. IRC § 877A(f)(4)(A).
35. IRC § 877A(f)(1)(B).
36. IRC § 2801.
37. IRC § 2801(a), (b).
38. IRC §§ 2801(c), 2503(b).
39. On July 16, 2009, the IRS announced that it intends to issue the new Form 708 and guidance on § 2801, including the due date of the return. Ann. 2009-57, 2009-29 IRB 158.
40. IRC § 2801(e)(4).
41. IRC §7701(a)(30)(E).
42. IRC §7701(a)(31)(B).
43. IRC § 2801(e)(4)(A).
44. IRC §§2801(e)(4)(B).
45. Id.
46. Id. As to income taxability of such distributions, see generally IRC § 6048(c)(2).
47. IRC §2801(d).
48. IRC §2801(e)(2).
49. IRC §§ 2101 et seq., 2501, 2511.
50. IRC § 2102(b)(1).
51. IRC §877A(g)(3), (4)(A) & (B).
52. Id.
53. IRC §§877A(g)(3)(B), 7701(b)(6); Treas. Reg. §301.7701(b)-1(b).
54. IRC §7701(b)(6) – flush language.
55. IRS Form 8854 – Expatriation Information Statement, General Information, Line F (at p. 1).
56. Instructions to IRS Form 8854, at numbered paragraph 3 on page 1.
57. IRC § 7701(b)(6).
58. See, e.g., U.S.-Australia Income Tax Treaty, Article 4, Paragraph 1.a.iii.; U.S.-France Income Tax Treaty, Article 4, Paragraph 1; U.S.-Germany Income Tax Treaty, Article 4, Paragraph 1.
59. French Tax Code, Article 4.B.

60. A treaty will have primacy over the Internal Revenue Code unless Congress intended that a specific revenue law override existing treaties. The legislative history of the 2008 HEART Act, which gave us the new alternative tax regime, does not address the effect on treaties. Therefore, it is reasonable to conclude that the HEART act does not override existing treaties.
61. Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Japan, the Netherlands, Norway, South Africa, Switzerland and the United Kingdom.
62. German Estate and Gift Tax Act § 16. The revised €400,000 exemption came into effect 1 January 2009.
63. U.S.-Germany Estate and Gift Tax Treaty, Article 9.
64. Id. at Article 11, Paragraph 1.a.iii.
65. Id. at Article 5. Real estate is referred to as "immovable property".