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INTERNATIONAL TAX
ADVISER

Helping Work Globally

A successful multi-national business or investor must consider the tax consequences of business or investment decisions. We can help you comply with tax reporting requirements that have a significant impact on your bottom line.

Not a Fond Farewell: The U.S. Exit Tax

On April 6, the *Wall Street Journal* reported that the number of American citizens and green card holders expatriating from the U.S. has increased dramatically in recent years. Among the reasons cited were increased U.S. tax regulation and higher tax costs. Legislation that became effective in June 2008 will exact a toll charge on some of those expatriates as they surrender their passports or green cards.

Formerly, U.S. citizens and long-term permanent residents who renounced their U.S. citizenship or residency were required to pay tax on an expanded definition of U.S. source income for 10 years following expatriation. In 2008, Congress passed legislation marking a significant change in the way in which U.S. income tax laws treat citizens and residents who expatriate from the United States. Affected expatriates are now required to pay what is, effectively, an exit tax.

The new legislation is applicable to "covered expatriates." A "covered expatriate" is any expatriate having an average annual income tax liability of more than an inflation adjusted amount ($145,000 in 2009 and 2010) for the five taxable years ending before expatriation or having a net worth of

more than $2,000,000 on the date of expatriation. However, a "covered expatriate" also includes an individual that fails to certify to the IRS that he has complied with all federal tax obligations for the five taxable years preceding expatriation or fails to submit evidence of the compliance as required by the IRS, regardless of that person's average annual tax liability or net worth.

A Mark to Market Exit Tax

The new legislation for covered expatriates imposes a tax on unrealized gains in excess of an applicable exclusion amount ($626,000 for taxable years beginning in 2009, $627,000 for taxable years beginning in 2010). These assets are treated as if they were sold for their fair market value on the day immediately before expatriation. Generally, this tax applies to all property held by covered expatriates except for deferred compensation income, interests in non-grantor trusts and specified deferred tax accounts.

The covered expatriate may make an irrevocable election to defer inclusion of the taxable gains until the date the assets are disposed. The taxpayer making this election will be subject to interest on the tax due on the unrealized gains and will have to provide adequate security (such as a bond or letter of credit) for the property until the tax is paid.

With minor exceptions, special rules apply for the purposes of calculating the amount of gain – a pro-taxpayer rule for determining basis on appreciated property. For example, unless an individual irrevocably elects otherwise, property held by an individual on the date the individual first became a resident of the United States is treated as having a basis of not less than the fair market value of such property on that date.

The mark to market tax is deferred only until the earlier of either the security provided for the property becoming adequate or the taxpayer's death. Since the election to defer the tax is irrevocable,

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the taxpayer should seek advice from professionals familiar with their tax situation before deciding whether or not to proceed with this election.

Interests in Trusts and Gifts

The mark to market tax also applies to expatriate interests in grantor trusts but not to interests in non-grantor trusts. A 30% withholding tax applies to direct or indirect distributions from non-grantor trusts. To avoid double taxation, expatriates in most cases may qualify for a dollar-for-dollar foreign tax credit to offset tax incurred on non-grantor trust distributions or most other types of income earned in the United States.

In the event a non-grantor domestic trust distributes property to a covered expatriate that was a beneficiary of the trust prior to expatriation, the trust must recognize a capital gain on the amount by which the fair market value of the property exceeds its cost basis. The trust must include this unrealized gain as a capital gain in its taxable income on the date before distribution and the expatriate will not be further taxed on this distribution.

Gifts or bequests given by a covered expatriate to an individual will be taxed at the higher of the highest estate or gift tax rate (35%). The taxpayer receiving the gift is able to deduct any foreign estate or gift taxes as credits against this transfer tax.

Under this provision, if a U.S. citizen or resident receives property directly or indirectly by gift from a covered expatriate, then the transfer is subject to a tax equal to the value of the gift multiplied by the highest rate of tax for federal or gift tax purposes (as of this writing, the federal estate tax rate is 0%; the highest marginal gift tax rate is 35%). The tax is payable by the recipient.

Deferred Compensation and Specified Tax Deferred Accounts

In general, the payor of "eligible deferred compensation" must withhold 30% of the taxable payment entitled to a covered expatriate under the new Section 877A rules. For purposes of the above law, "eligible deferred compensation" is defined as a taxable payment to a covered expatriate from a U.S. person that is notified by the payor of their expatriation and irrevocably waives any right to a reduced withholding under an existing tax treaty.

Deferred compensation that does not qualify as "eligible deferred compensation" is treated as having been received or, if restricted property, is considered transferable and no longer subject to substantial risk of forfeiture on the day immediately before the date of expatriation. In other words, the act of expatriating with respect to this category of deferred compensation will generally trigger a taxable event.

Specified tax deferred accounts are treated as having fully distributed a covered expatriate's entire interest in the account the day before expatriation and, as such, are taxed at ordinary individual tax rates. Specified tax deferred accounts include individual retirement plans, qualified tuition savings plans, and health savings accounts. This taxable distribution is not subject to any early withdrawal taxes.

All in all, the United States "exit tax" is designed to protect the integrity of the public treasury. It targets what can generally be identified as the "as yet" untaxed income (i.e., deferred compensation, capital gains, etc.) of expatriating individuals that arose while those individuals were U.S. citizens or residents.

Determining the items includable in the calculation, determining the proper timing of income inclusions, and understanding the appropriate tax planning surrounding the expatriation event can be – in a word – complex.

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