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Details of New Tax Laws Applicable to Expatriates

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Tax professionals advising former US citizens and long-term residents should take note that the American Jobs Creation Act 2004 has eliminated the tax avoidance motive test previously applied to determine whether an individual was subject to the 10-year alternative income tax regime and the expatriate estate and gift tax rules following expatriation. The act further amends the gift and estate tax rules to address concerns of tax avoidance opportunities for assets owned by expatriates through foreign corporations. This update provides details of the current state of the US tax laws applicable to former US citizens and long-term residents. For a summary of other changes relevant to tax professionals advising international families and their trustees please see "Tax Law Changes under the American Jobs Creation Act 2004".

Income Tax

Tax status following expatriation

A person who expatriates after June 3 2004 continues to be subject to income tax as a US citizen or resident until that individual (i) gives notice to the secretary of state or the secretary of homeland security that he or she has intentionally undertaken an expatriating act or terminated US residency, and (ii) files a statement that includes the following information:

- US taxpayer identification number;
- mailing address of principal foreign residence;
- foreign country of residence;
- foreign country of citizenship;
- details of income, assets and liabilities;
- number of days present in the United States during the tax year; and
- any other information the Internal Revenue Service (IRS) requires.

A common expatriating act is the making of a formal renunciation of nationality before a US diplomatic or consular officer in a foreign country. Although there is no specific prohibition on dual nationality under current US law, certain acts relevant to the acquisition of foreign nationality may, when undertaken voluntarily and with the intent to give up US nationality, be considered an expatriating act, such as formally declaring allegiance to another country or serving in a foreign army.

A long-term resident who relinquishes his or her US green card or 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, and who does not waive treaty benefits applicable to residents of the foreign country, will be treated for tax purposes as if he or she were a former citizen of the United States. A 'long-term resident' is an individual who has been a lawful permanent resident of the United States in at least eight taxable years during the period of 15 taxable years ending with the year in which the individual relinquishes his or her US green card or commences to be treated as a resident of a foreign country.

An individual who has complied with the notice and filing requirements will thereafter be subject to either the US income tax imposed on non-resident aliens or the 10-year alternative income tax imposed on expatriates who meet specified income tax or worth criteria. The alternative income tax modifies the tax rules generally applied to non-resident aliens by:

- subjecting the expatriate's US-source income to US-citizen income tax rates rather than the flat tax rate imposed on non-resident aliens;

- not applying the exemption from US capital gains tax available to non-resident aliens for gains on the sale of US situs property or US issued securities;

- taxing exchanges of certain US-source income property for foreign-source income property; and

- treating an expatriate as receiving income or gain directly from property contributed to a controlled foreign corporation.

For further details of US tax imposed on non-resident aliens please see the Overview (September 2004).

Objective income tax and net worth tests

For persons expatriating after June 3 2004, the reasons for expatriating are now irrelevant in determining whether the expatriate is subject to the 10-year alternative income tax rules. Instead, the alternative income tax applies to any expatriate:

- whose average annual net income tax for the period of five taxable years ending before the date of the loss of US citizenship is greater than $124,000 (increased by a cost-of-living adjustment for calendar years after 2004);

- whose net worth is $2 million or more as of the date of the loss of US citizenship; or

- who fails to certify under penalty of perjury that he or she has met the requirements of the Internal Revenue Code for the five preceding taxable years or fails to submit evidence of compliance as required by the IRS.

The expatriate must pay the alternative tax (after reducing it for the payment of foreign taxes) if it is greater than the ordinary tax imposed on non-resident aliens.

Exceptions

Although very limited exceptions, the average income tax and net worth tests will not be applied to certain dual citizens or to certain individuals who expatriate while still minors. An individual will be considered a dual citizen and not subject to the alternative 10-year tax if he or she:

- was born a citizen of the United States and another country;
- continues to be a citizen of the other country; and
- has had no substantial contacts with the United States.

'No substantial contacts' means that the individual:

- was never a resident of the United States;
- has never held a US passport; and
- was not present in the United States for more than 30 days during any calendar year which is one of the 10 calendar years preceding loss of US citizenship.

An expatriate is also not subject to the alternative 10-year tax, regardless of income or net worth, if:

- he or she became at birth a citizen of the United States;
- neither parent was a citizen of the United States at the time of the individual's birth;

- his or her loss of US citizenship occurs before he or she attains age 18-and-a-half; and

- he or she was not present in the United States for more than 30 days during any calendar year which is one of the 10 calendar year preceding loss of US citizenship.

Annual statement filing

The statement provided with the notice of an expatriating act or termination of residency (described above) must be filed annually by all expatriates subject to the alternative tax. A penalty of $10,000 will be imposed if the statement is not timely filed, fails to include the required information or includes incorrect information, unless it can be shown that the failure is due to reasonable cause and not wilful neglect.

Physically present in the United States more than 30 days

Prior to the American Jobs Creation Act 2004, even individuals who expatriated for tax reasons could continue to spend significant amounts of time in the United States - as much as four months a year - without being taxed as US residents. Now, an expatriate subject to the 10-year alternative tax rules will instead be taxed as a US citizen and resident if he or she is physically present in the United States at any time during the day on more than 30 days in a year during the 10-year period following expatriation. The general exceptions for presence, such as certain medical conditions and exempted individuals, used in defining resident aliens do not apply to expatriates subject to the alternative tax.

Limited employment exception

A day of physical presence (not in excess of 30) will, however, be disregarded if an expatriate with certain ties to countries other than the United States is performing services in the United States on that day for an employer and has had minimal prior physical presence in the United States. An expatriate has ties to another country for purposes of the employment exception if he or she (i) became a citizen or resident of the country in which the individual was born, or, if married, in which the spouse was born, or in which either of the expatriate's parents were born, and (ii) is fully liable for income tax in that other country.

Minimal prior physical presence is met if, for each year in the 10-year period ending on the date of expatriation, the individual was physically present in the United States for 30 days or less. Here the medical condition exception applies, so that the expatriate will not be treated as having been present in the United States on any day that he or she could not leave the country because of a medical condition that arose while he or she was in the United States.

The exception for days of employment does not apply where the expatriate is working for an employer which is related (as defined in the Internal Revenue Code) or fails to meet any requirements the IRS may prescribe to prevent avoidance of these rules.

Estate Tax

The expatriate estate tax rules now apply to any expatriate who dies during the 10-year period during which he or she is subject to the alternative income tax regime described above, regardless of the purpose for expatriating. The estate of such an expatriate will include for US estate tax purposes his or her US situs property (including US real estate and tangible property physically located in the United States, and securities or obligations issued by US persons or entities), and a portion of his or her stock in foreign corporations in which the decedent owned: (i) directly, 10% or more of the combined voting power of all the foreign corporation's voting stock; and (ii) directly or indirectly, more than 50% of the foreign corporation's total voting stock or more than 50% of the total value of all stock.

The includible portion of foreign stock is calculated using the ratio that the fair market value of the US situs assets owned by the corporation bears to the corporation's total assets. For further information on US estate tax rates, exemptions and credits please see the Overview (September 2004).

Gift Tax

Similarly, the expatriate gift tax rules now apply to any expatriate who makes a taxable gift during the 10-year period during which he or she is subject to the alternative income tax regime, regardless of the purpose for expatriating. In addition to tax on gifts of US situs real estate and tangibles, the expatriate will be liable for gift tax on transfers of US situs intangibles such as stock in US corporations and the US asset value of gifts of stock in certain foreign corporations. The US asset value is an amount bearing the same ratio to the stock's fair market value at the time of the gift as the fair market value of the corporation's US situs assets bears to the total fair market value of all the corporation's assets.

The gift tax rules apply regardless of how the expatriate acquired the stock. However, stock in a foreign corporation owned by such an expatriate is subject to the gift tax rules only if the expatriate: (i) owned, directly or indirectly, 10% or more of the total combined voting power of all classes of stock entitled to vote; and (ii) owned, directly or indirectly, or is considered to have constructively owned, more than 50% of the total combined voting power of all classes of stock entitled to vote, or the total value of the corporation's stock.

There is a credit available to reduce the gift tax by the amount of any gift tax the expatriate pays to any foreign country on the gift. For further information on US gift tax rates, exemptions and credits please see the Overview (September 2004).

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