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New Tax Law Applicable to Expatriates

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- **Prior Law Extended US Income Tax Treatment**
- **Covered Expatriate**
- **New Law Imposes Exit Tax**
- **Tax on Gifts and Bequests from Covered Expatriate**
- **Comment**

US citizens and long-term residents who are considering relinquishing their US citizenship or terminating their US residency need to consider the impact of the new mark-to-market deemed sale rule ushered in by the Heroes Earnings Assistance and Relief Tax Act 2008.

Prior Law Extended US Income Tax Treatment

Previously, an expatriating individual who had complied with the required notice and tax filing requirements was thereafter 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 net-worth criteria (known as 'covered expatriates') (for more details please see the Overview (March 2008)). Covered expatriates relinquishing US citizenship or terminating US residency after June 3 2004 and prior to June 17 2008, the effective date of the act, will continue to be subject to the 10-year alternative income tax rules.

Covered Expatriate

Both the new deemed sale rule and the previous 10-year alternative income tax rules apply only to covered expatriates.

Income and net-worth tests

A covered expatriate includes individuals who meet specified income and net-worth criteria. A covered expatriate is an individual:

- 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 $139,000 (for tax year 2008, subject to an annual cost-of-living adjustment);
- whose net worth is $2 million (not indexed for inflation) 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 Internal Revenue Service (IRS).

Exceptions

A covered expatriate does not include a dual national from birth where, following expatriation, the individual continues to be a citizen and tax resident of that other country, provided that the dual national has not been resident in the United States (under the income tax substantial presence test) for more than 10 of the last 15 years. It also does not include persons under 18 and a half years of age who have not been US resident for more than 10 years under the income tax substantial presence test.

Under the 10-year alternative income tax rules, covered expatriates who spent more than 30 days in a calendar year in the United States will find themselves subject to full US income tax liability. This 30-day rule does not apply under the new deemed sale rule, so that a covered expatriate may spend time in the United States without becoming taxable as a US person, unless he or she becomes US tax resident under the income tax substantial presence test (for more details of the substantial presence test please see the Overview (March 2008)).

New Law Imposes Exit Tax

The new deemed sale rule will treat most of a covered expatriate's worldwide property as if it had been sold for its fair market value on the day before expatriation. The covered expatriate will owe income tax on any resulting recognized gain in excess of a $600,000 exemption amount (adjusted annually for inflation), but only with respect to appreciation that occurred while the covered expatriate was a US citizen or lawful permanent resident.

Deferred compensation and tax deferred accounts

With respect to eligible deferred compensation items (most interests in pension or similar retirement plans, certain annuity plans and property to be received in connection with the performance of services), these amounts will not be taxed under the new deemed sale rule. Instead, upon distribution to a covered expatriate, the plan administrator will be required to deduct and withhold a tax of 30% from that portion of the distribution that would have been included in the gross income of the covered expatriate if such person were a US citizen or resident. To be eligible, the payee must notify the plan administrator that he or she is a covered expatriate and irrevocably waive any right to claim a reduction or refund of the withholding tax pursuant to any tax treaty.

Specified tax deferred accounts (eg, individual retirement accounts and health savings accounts) will be treated as if the covered expatriate received a distribution of his or her entire interest on the day before the expatriation date. The covered expatriate will be subject to income tax on the amount deemed distributed (with adjustments made to subsequent distributions to account for this), but not subject to early distribution taxes applicable to actual distributions from such accounts.

Grantor and non-grantor trusts

Where a covered expatriate is treated as the owner of a trust, or a portion thereof, under the grantor trust rules, the assets held by that trust or portion of the trust are subject to the deemed sale rule upon expatriation. The deemed sale rule does not generally apply to non-grantor trusts (for an explanation of when a trust is considered a grantor trust or non-grantor trust for US tax purposes, please see "Taxation of Offshore Trusts and Impact of New Lower Tax Rates").

The trustee of a non-grantor trust, before making a direct or indirect

distribution to a covered expatriate, must deduct and withhold an amount equal to 30% of such part of the distribution portion that would have been includable in the covered expatriate's gross income if he or she were still subject to US income tax. The covered expatriate is treated as having waived any right to a treaty reduction in the amount withheld. If the trustee distributes appreciated property to a covered expatriate, the trust is treated as having sold the property for its fair market value and must recognize any gain.

If a non-grantor trust converts to a grantor trust, the covered expatriate, who is considered the trust's owner, is treated as having received a distribution from the trust, which will trigger the 30% withholding tax. If a grantor trust converts to a non-grantor trust after the individual expatriates, such trust will continue to be treated as a grantor trust for purposes of the new rules. The impact of the new deemed sale rule upon the change of a trust's tax status is important to note because the expatriation of the trust's grantor can cause a grantor trust to become classified as a non-grantor trust for US income tax purposes.

Election to extend time for payment

A covered expatriate may irrevocably elect to extend the time for payment of the tax resulting from the deemed sale on a property-by-property basis, provided he or she is willing to provide the IRS with a bond or other form of security. The tax will thereafter be due when the applicable items of property are actually disposed of (or upon the date of such covered expatriate's death, if earlier). The covered expatriate must also waive any right to claim treaty benefits with respect to such tax liability in order to qualify for the election. Interest on the deferred tax will be charged at the individual underpayment rate (currently 6%).

Tax on Gifts and Bequests from Covered Expatriate

In addition to the exit tax to be paid by the covered expatriate, the act imposes a transfer tax on US persons who receive gifts or bequests from the covered expatriate.

Covered gifts and bequests

The tax applies to certain gifts and bequests in excess of the $12,000 annual exclusion amount (adjusted annually for inflation). Gifts and bequests to a US citizen spouse or US charity are not subject to the tax. Covered gifts and bequests do not include property on which the covered expatriate or his or her estate is otherwise subject to gift or estate tax and which is reported on a timely filed gift or estate tax return. Tax on covered gifts and bequests will be imposed at the highest gift or estate tax rate then in effect (45% for 2008), less any foreign gift or estate tax paid.

Income and net-worth tests applied at time of transfer

The determination of whether the transferor is a covered expatriate is made at the time of the gift or upon his or her death, regardless of whether the transferor was a covered expatriate at the time of expatriation. Thus, a US person may be subject to the new gift or estate tax upon the receipt of a gift or bequest from an individual whose wealth increased following expatriation, or who expatriated prior to the effective date of the act, but is considered a covered expatriate as of the time of the gift or bequest.

Domestic trusts and foreign trusts

The trustee of a domestic trust that receives a covered gift or bequest must pay the tax from the trust. The trustee of a foreign trust does not. Instead, the US beneficiary of the foreign trust pays the tax when he or she receives a distribution attributable to such gift or bequest. A foreign trust may elect to be treated as a domestic trust for purposes of the new gift and estate tax.

Comment

The new deemed sale rule does away with the continuing US tax liability of the 10-year alternative income tax rules. It also does away with the ability to mitigate the tax; careful asset planning under the 10-year alternative income tax rules could lighten the tax burden, whereas the deemed recognition of gain on worldwide assets under the new rules cannot be avoided. But as it is a deemed sale, the taxpayer may not have the ready cash to pay the tax, and under some income tax treaties the deemed recognition may not be a creditable tax.

As for enforcement, it remains to be seen how the IRS will be able to enforce the new deemed sale rule, especially with respect to foreign trustees, as the rules applicable to non-grantor trusts apply to both domestic and foreign non-grantor trusts.

For further information on this topic please contact Jennie Cherry at Kozusko Harris Vetter Wareh LLP by telephone (+1 212 980 0010) or by fax (+1 212 751 0084) or by email (jcherry@kozlaw.com).

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