New Guidance on US Expatriation Exit Tax

By **Andrew Stone** and **David Adler**

Late in 2009, the US Department of Treasury published guidance concerning the exit tax applicable to expatriates and former long-term green card holders. The Heroes Earnings Assistance and Relief Tax Act of 2008 (the HEART Act) created a "mark-to-market" exit tax applicable to certain US citizens and long-term green card holders who expatriate or relinquish their green cards, as well as a succession tax on certain US citizens or residents who receive gifts or bequests from these individuals.

A long-term green card holder is a person who has been a lawful permanent resident of the United States for at least eight of the past 15 taxable years. Green card holders should take particular note of the exit tax regime, as the revocation or expiration of a green card can trigger the application of the exit tax.

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Under the mark-to-market exit tax regime, an expatriating individual who has a net worth of at least US$2 million or an average income tax liability for the previous five years of at least US$145,000 (2010 figure, adjusted annually for inflation), or who fails to certify as to compliance with all US federal tax obligations for the previous five years, will be deemed to have sold their worldwide assets for fair market value on the day before expatriation. This "covered expatriate" (CE) will pay tax on any resulting net gains in excess of an inflation-adjusted exclusion amount, currently US$627,000. US persons receiving gifts or bequests from a CE will be taxed on those gifts or bequests at the highest gift or estate tax rate in effect at that time. Excepted from this succession tax are transfers to spouses and charities. On 15 October 2009, the US Treasury released guidance concerning the exit tax and related issues in Notice 2009-85 (the Notice). Guidance on the succession tax will be issued separately.

The Notice provides that the application of the tax liability and net worth tests, which are used to determine whether a CE is subject to the exit tax, continues to be governed by Section III of Notice 97-19. Notice 97-19 provides that the entire net income of joint filers is included for the purpose of the tax liability test, and that all property subject to gift tax if owned by a US person, as well as all property in which a use right is held, are included for the purpose of the net worth test.

> Expatriation will not eliminate exposure to US income tax on US source income.

A CE will include in their exit tax base any interest in property that would have been taxable as part of their gross estate for federal estate tax purposes had they died a citizen or resident of the United States on the day before expatriating. A CE must therefore obtain a fair market value appraisal of any property and attach the appraisal to the final US income tax return.

For the purpose of determining the exit tax base, the CE will be deemed to own a beneficial interest in each nongrantor trust (any trust that is not treated as a grantor trust as to the CE) that would not be included in the CE's gross estate and that is not a nongrantor trust subject to the statutory withholding regime. A CE may elect out of the withholding regime for distributions from nongrantor trusts by electing to include their interest in the trust in the exit tax base. A private letter ruling as to value is a condition of this election. A CE who is a beneficiary of a nongrantor trust and does not elect to include the value of their interest in the exit tax base must file a Form W-8CE with the trustee. A CE with any interest in a nongrantor trust on the day before expatriation must file a Form 8854 annually to certify that no distributions have been received or to report the distributions received, unless the CE elected to have their entire interest in the trust included in the exit tax base.

The Notice further provides that the exclusion of the first US$627,000 (for 2010) of net gain from the exit tax is to be allocated *pro rata* among all assets included in the exit tax base. This method is significant because a taxpayer may elect to defer the exit tax payable with respect to a particular asset, provided that security for the ultimate payment of the tax is posted and interest is paid over the deferral period. Losses may be taken into account only to the extent permitted by the Internal Revenue Code, *i.e.*, subject to the annual capital loss carryforward limitation of US$3,000.

A CE receives a basis adjustment for the amount of gain or loss deemed realised without regard to the current US$627,000 exclusion amount. This is, however, of little value for property other than US *situs* real estate or business property, as nonresident aliens are generally not subject to US tax on capital gains. In relation to the rule that allows inbound nonresident aliens a step up in basis for property held on the first day the alien becomes tax resident, the Notice warns that Treasury intends to exclude generally any property that is a "United States real property interest" and any property used or held for use in connection with the conduct of trade or business within the United States.

Recipients of "ineligible deferred compensation"—basically deferred compensation for which the payor is not a US person or does not otherwise assume the responsibility for withholding—must file a W-8CE with the payor. The payor is required to provide a written statement outlining the current value of the CE's accrued benefit on the day before the expatriation date. This amount is then included in the CE's exit tax base. A CE who was a citizen or long-term resident for only part of the taxable year must file a dual status return (a Form 1040NR with a Form 1040 attached as a schedule). In addition, all CEs must file with their final income tax return a certification on Form 8854 that the CE has been in compliance with all federal tax laws during the five years preceding the year of expatriation.

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The benefit of expatriating under the new mark-to-market exit tax regime is the removal of non-US source income from the jurisdiction of the US income tax, and the removal of non-US *situs* property from the jurisdiction of the US estate, gift and generation-skipping transfer tax. As the basis in loss assets will be stepped down to fair market value on expatriation, however, there is a risk of creating phantom gain on the subsequent disposition of such properties that are US real or business property. Expatriation will not eliminate exposure to US estate, gift and generation-skipping transfer tax on *inter vivos* or testamentary transfers of property that is deemed situated in the United States for gift or estate tax purposes, as applicable. Nor will it eliminate exposure to US income tax on US source income. Expatriation also creates exposure to the succession tax if gifts or bequests to US persons are contemplated. For taxpayers possessing assets with substantial built-in losses, however, the present time may be an attractive time to expatriate if the exit tax cost for doing so is low.

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