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President Signs Exit Tax for U.S. Expatriates

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Giving up a U.S. passport now carries a steep price tag. A new law enacted on 17 June 2008 subjects certain individuals who expatriate or give up their green cards to immediate tax on the inherent gain on all of their worldwide assets and a tax on future gifts or bequests made to a U.S. citizen or resident.

Tax practitioners had been made to feel like the boy who cried wolf in recent months as the U.S. Congress repeatedly threatened to enact legislation aimed at U.S. citizens who expatriate. Congress finally made good on those threats by unanimously passing the Heroes Earning Assistance and Relief Tax (HEART) Act (the 'Act'), which provides tax relief for active duty military personnel and reservists.

The new tax regime applies to certain individuals who relinquish their US citizenship and certain long-term U.S. residents (i.e., green card holders) who terminate their U.S. residence (hereafter referred to as 'expatriates'). The so-called 'mark-to-market' tax applies to the net unrealized gain on the expatriate's worldwide assets as if such property were sold (the 'deemed sale') for its fair market value on the day before the expatriation date. Any net gain on this deemed sale in excess of US$600,000 is taxable.

In addition, trustees of non-grantor trusts must withhold and pay over to the IRS 30 percent of the portion of any distribution (whether direct or indirect) that would have been taxable to the expatriate had he not expatriated. Failure to withhold the tax could subject the trustee to direct liability for the unpaid U.S. tax.

Non-U.S. persons who are considering becoming citizens or obtaining green cards should think twice before doing so as the cost of leaving the U.S. in the future may be very high.

Individuals Covered

The Act applies to any expatriate if that individual (i) has a net worth of US$2 million or more; (ii) has an average net U.S. income tax liability of greater than US$139,000 for the five year period prior to expatriation; or (iii) fails to certify that he has complied with all U.S. federal tax obligations for the preceding five years (the 'covered expatriate').

The Act contains two exceptions, which are broader than those contained in prior law. An individual is not a 'covered expatriate' if he certifies compliance with US federal tax obligations as specified in item (iii) above, and: (i) he was at birth a citizen of the U.S. and another country, provided that (a) as of the expatriation he continues to be a citizen of, and a tax resident of, such other country, and (b) he has been a resident of the U.S. for no more than 10 of the 15 taxable years ending with the taxable year of expatriation; or (ii) he relinquishes U.S. citizenship before reaching the age of 18 ½, provided that he has been a resident of the U.S. for not more than 10 taxable years before relinquishment.

In General

The Act consists of three key elements:

1. The mark-to-market tax on the covered expatriate's worldwide assets;
2. A tax on certain gifts and bequests made by the covered expatriate to any US person; and
3. A repeal of the current so-called 10-year shadow period for covered expatriates.

The Mark-to-Market Tax

As noted above, the mark-to-market tax now applies to the net unrealized gain on the covered expatriate's worldwide assets as if such property were sold for its fair market value on the day before the expatriation date to the extent that the net gain exceeds US$600,000.

However, as discussed below, the mark-to-market tax does not apply to (i) certain deferred compensation items; (ii) certain specified tax deferred accounts; or (iii) any interest in a nongrantor trust.

A. Deferred Compensation Items

Under the Act, certain deferred compensation items are subject to the mark-to-market tax. For purposes of this calculation, the covered expatriate is deemed to receive the present value of his accrued benefit on the day before the expatriation date. No early distribution excise tax applies by virtue of this treatment, and appropriate adjustments must be made to subsequent distributions from the plan to reflect such treatment.

Other qualifying deferred compensation items are not subject to the mark-to-market tax; however, the payor must deduct and withhold a tax of 30 percent from any taxable payment to a covered expatriate. A taxable payment is subject to withholding to the extent it would be included in the gross income of the covered expatriate if such person were a U.S. citizen or resident.

B. Specified Tax Deferred Accounts

Under the Act, the mark-to-market tax applies to certain specified tax deferred accounts. In the case of any interest in a specified account held by a covered expatriate on the day before the expatriation date, the expatriate is deemed to receive a distribution of his entire interest in the account on that date. Appropriate adjustments are made for subsequent distributions to take into account this treatment. Such deemed distributions are not subject to additional tax.

C. Interests in Non-Grantor Trusts

The Act makes a distinction between grantor trusts and non-grantor trusts. A grantor trust is ignored as a taxable entity for U.S. federal income tax purposes. The 'owner' of a grantor trust must include in computing his personal tax liability the items of income, deduction and credit that are attributable to the trust.

Therefore, in the case of the portion of any trust for which the covered expatriate is treated as the owner under the grantor trust provisions, the assets held by that portion of the trust are subject to the mark-to-market tax.

The mark-to-market tax does not generally apply to non-grantor trusts. Rather, in the case of any direct or indirect distribution from the trust to a covered expatriate, the trustee must deduct and withhold an amount equal to 30 percent of the distribution portion that would be includable in the gross income of the covered expatriate if he were subject to U.S. income tax. The covered expatriate waives any right to claim a reduction in withholding under any treaty with the U.S. The Act does not explain how the withholding will be enforced against a non-U.S. trustee of a trust.

In addition, if the non-grantor trust distributes appreciated property to a covered expatriate, the trust recognizes gain as if the property were sold to the expatriate at its fair market value.

If a non-grantor trust becomes a grantor trust of which the covered expatriate is treated as the owner, such conversion is treated as a distribution to the covered expatriate and will trigger the 30 percent withholding tax.

Conversely, if a grantor trust becomes a non-grantor trust after the individual expatriates, it appears that the mark-to-market tax applies to assets in the grantor trust, and the 30 percent withholding requirement does not apply to the trust once it becomes a non-grantor trust. This is an important point because the grantor's expatriation commonly converts grantor trusts into non-grantor trusts.

Tax on Gifts and Bequests to U.S. Citizens or Residents

The Act taxes certain 'covered gifts or bequests' received by a U.S. citizen or resident. The tax, which is assessed at the highest marginal estate or gift tax rate at the time of the gift or bequest, applies only to the extent that the covered gift or bequest exceeds US$12,000 during any calendar year. The tax is reduced by the amount of any gift or estate tax paid to a foreign country with respect to such covered gift or bequest. No allowance appears to exist for the US$1 million exemption from U.S. gift tax or the US$2 million exemption from U.S. estate tax normally granted to U.S. persons. Gifts or bequests made to a U.S. spouse or a qualified charity are not subject to the tax.

In the case of a covered gift or bequest made to a U.S. trust, the tax applies as if the trust were a U.S. citizen, and the trust is required to pay the tax. In the case of a covered gift or bequest made to a foreign trust, the tax applies to any distribution, whether from income or corpus, made from such trust to a recipient who is a U.S. citizen or resident, in the same manner as if such distribution were a covered gift or bequest.

Repeal of 10-Year Shadow Period

Prior law subjected expatriates to a so-called 10-year shadow period, which resulted in a covered expatriate being taxed as a U.S. citizen in any of the 10 years following expatriation in which the expatriate spent 30 days in more in the U.S. In addition, prior law taxed expatriates on all U.S. source income and gain during the shadow period.

Under the Act, individuals who expatriate on or after the date of enactment are not subject to the shadow period but are instead subject to the mark-to-market tax and the tax on gifts and bequests to U.S. citizens and residents.

Conclusion

In light of the Act, individuals who are considering expatriation should consider the substantial new tax burdens that this action now generates. Those persons who expatriate after 17 June and who are considering making gifts or bequests to U.S. persons in the future should also review their planning. In addition, trustees should very carefully consider whether trust beneficiaries are covered expatriates before making any distribution without withholding U.S. tax. Trustees who fail to become familiar with the new rules do so at their peril.

Because trust distributions may occur many years after expatriation and bequests will only occur upon death, covered expatriates will need to consider their U.S. tax obligations for the rest of their lives. In this respect, the Act makes a bold statement to those who expatriate from the U.S.: you can walk away, but you can never really leave.

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