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The Expatriation Tax Regime: Surprises, Problems, and Planning Techniques

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The Heroes Earnings Assistance and Relief Tax (HEART) Act of 2008 adopted new tax rules for expatriates, i.e., persons ceasing to be U.S. citizens or long-term green card holders. A key feature of these rules is an exit tax, meaning that the expatriate is taxed on a mark-to-market basis and also deemed to receive certain deferred income. Another key feature is an inheritance tax applicable to the expatriate's future gifts or bequests to U.S. persons.

The expatriation tax rules have been the subject of substantial discussion, in the professional literature and elsewhere.[2] This article highlights pre-expatriation compliance, pre-expatriation gifts, post-expatriation estate planning, the treatment of deferred compensation, and other issues. These and other issues should be considered when advising clients who are considering expatriating or (worse) who have already expatriated and now just need to ''file their tax returns.''

WHAT'S THE WORST THAT CAN HAPPEN?

They might not be the ''worst,'' but following are some of the very bad things that can happen as a result of expatriating:

- An expatriate may be taxed on assets that are illiquid, taxed on assets not owned, and taxed on deferred compensation not eligible to be paid (which may be unvested or otherwise may never be paid);
- An expatriate may owe the foregoing taxes to the United States, and owe taxes for the same assets and income to another country. The usual mechanism for avoiding or minimizing double taxation (foreign tax credits) often will not be available; and

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[2] See in particular Rubin, ''IRS Expatriation Guidance Is Helpful, But Also Overreaches,'' 39 *Tax Mgmt. Int'l J.* 3 (Jan. 2010), and Stegman, ''The New U.S. Exit Tax Scheme: Breaking Off a Long-Term Relationship with Uncle Sam,'' *Trusts & Trustees* (March 2012), p. 1. *See also* Sebastian, ''New Exit Taxes for the U.S. Expatriate,'' *Virginia State Bar Trusts and Estates Newsletter* (Fall/Winter 2009); ''Planning for Expatriation of Individuals: New Section 877A and 2801,'' www.procopio.com/assets/014/6879.pdf, Oct. 19, 2009; Toce, Jr. and Kluemper, ''Estate Planning for Expatriation Under Chapter 15(c),'' 40 *Estate Planning* 3 (Jan. 2013); Johnson, ''Observations on America's New Expatriation Rules,'' undated, from wrjassoc.com/publications/.

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- Gifts and devises made by expatriates may incur more U.S. transfer taxes than are applicable to transfers by U.S. persons. They may even be subject to double U.S. transfer taxes (i.e., applicable to the expatriate donor and a U.S. recipient) on the same gift, due to foot-fault compliance violations.

These particular issues are discussed in more detail below.

ARE YOU A COVERED EXPATRIATE?

The exit and inheritance taxes imposed by §§877A and 2801 of the Internal Revenue Code of 1986, as amended (the Code),[3] only apply with respect to ''covered expatriates.'' In general, you are a covered expatriate if you have a compliance failure, pass an income tax threshold, *or* pass a net worth threshold. (Certain aspects of these triggers are discussed below.)

Potentially severe consequences attach to covered expatriate status, and significantly different planning (before and after expatriation) may be appropriate depending on whether or not a person is a covered expatriate. Thus, great care must be taken to determine whether or not you are a covered expatriate. As will be seen, in some cases there may be uncertainty as to whether one is a covered expatriate. For example, there may be uncertainty as to whether the expatriate is above the net worth threshold, which may depend on, among other things, the valuation of illiquid assets and nuances of the gift tax rules.

PAST COMPLIANCE FAILURES (NO MATTER HOW SMALL) ARE NEITHER FORGOTTEN NOR FORGIVEN

You are a covered expatriate if you have a compliance failure. More specifically, under §877A(g)(1), you are a covered expatriate if you fail to certify under penalty of perjury that you have met the requirements of the Code for the preceding five taxable years, or fail to document this compliance as may be required by the IRS. Query whether an expatriate is a covered expatriate if he certifies that he has no compliance failures, but such certification is incorrect. (Presumably he is, even though he made the required certification.)

Compliance failures include failing to file income tax returns, report income, or pay tax due. Even more problematic for U.S. taxpayers living abroad are failures to comply with the proliferating U.S. information reporting requirements. Notice 2009-85[4] states that compliance is required for ''all'' such requirements, including ''information returns.'' There appears to be no reasonable cause, *de minimis*, or comparable exception. Thus, for example, you would appear to be a covered expatriate if you report your controlled foreign corporation on Form 5471, but miss a (wholly duplicative) Form 8938 filing obligation.

Compliance failures can be of particular importance to certain dual nationals and other persons excluded by §877A(g)(1)(B) from the income tax and net worth tests. That is, such a person will not be a covered expatriate merely because their income tax and/or net worth pass the applicable thresholds, but they will be a covered expatriate if they have a compliance failure.

A person who otherwise would not be a covered expatriate should consider correcting past compliance failures prior to expatriating. Correcting such failures may raise significant issues independent of expatriation, however, such as potentially owing back taxes, interest, and penalties. Moreover, should corrections be made ''quietly'' by filing or amending applicable returns and paying applicable interest and penalties? ''Noisy'' corrections, such as through the IRS Offshore Voluntary Disclosure Program, may take years, which may be inconsistent with the expatriate's plans.

THE INCOME TAX THRESHOLD IS BASED ON *U.S.* INCOME TAX

You are a covered expatriate if you pass an income tax threshold. More specifically, under §877A(g)(1) (inflation-adjusted by Rev. Proc. 2012-41[5] for 2013), you are a covered expatriate if your average *U.S.* income tax liability for the preceding five taxable years exceeds $155,000. For this purpose, §877(a)(2)(A) computes income tax liability after taking into account certain credits, including foreign tax credits. Thus, a high-income individual residing in a high-tax jurisdiction (e.g., the United Kingdom or France) may fall below this threshold, because their U.S. tax liability may be largely or even wholly offset by foreign tax credits.

PLANNING THROUGH PRE-EXPATRIATION GIFTS

Pre-expatriation gifts may serve two (or more) purposes. First, they may permit the expatriate to stay be-

[3] Unless otherwise indicated, all ''§'' references are to the Code, and all ''Regs. §'' references are to the Treasury regulations promulgated thereunder (and set forth in 26 CFR).

[4] 2009-45 I.R.B. 598 (10/15/09).

[5] 2012-45 I.R.B. 539 (10/18/12).

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low the net worth threshold of $2 million imposed by §877A(g)(1), and thus not be a covered expatriate merely due to net worth. In this connection, it may be possible to reduce net worth through an ''expatriation trust.''[6]

Second, a covered expatriate may make pre-expatriation gifts strategically to minimize his mark-to-market tax (by giving away appreciated assets) and to minimize future inheritance tax (by making gifts to U.S. persons prior to expatriating, up to or even in excess of the $5,250,000 gift tax exclusion for 2013).

Under the limited guidance issued to date, the nuanced treatment of partial interests in property may have significant consequences. For purposes of determining whether a person is a covered expatriate, Notice 2009-85 determines net worth based on *gift tax* principles. On the other hand, in applying the mark-to-market tax, Notice 2009-85 values a covered expatriate's assets based on *estate tax* principles. Thus, for example, if an expatriate gifts a residuary interest in an asset and retains the related life estate: (1) only the value of the life estate counts toward the expatriate's net worth (and potentially the life estate would be assigned no value, under §2702 principles), but (2) the value of the entire asset (including under §2036(a) the residuary interest given away) is subject to the mark-to-market tax. Subjecting the residuary interest to the mark-to-market tax is not only a harsh result, but arguably not the correct result under the applicable statutory language.[7]

An expatriate should be prepared to defend pre-expatriation gifts. Form 8854, which must be filed by any expatriate (covered or not), requires a statement explaining any ''significant changes in your assets and liabilities'' for the five years preceding expatriation.

ESTATE PLANNING MAY BECOME EVEN MORE COMPLICATED

If your likely heirs and beneficiaries are U.S. persons, you may be trading ''bad'' U.S. gift and estate taxes for a ''worse'' U.S. inheritance tax. This is because, under §2801(a), a U.S. citizen, resident, or trust receiving a gift or devise from a covered expatriate is subject to an inheritance tax at the highest applicable gift or estate tax rate.

Features of this inheritance tax include:

- The annual exclusion of $14,000 applies under §2801(c), but the unified lifetime gift/estate tax exclusion of $5,250,000 does not. Thus, a covered expatriate should consider exhausting the unified lifetime exclusion prior to expatriating.
- It applies to any gift or devise from a covered expatriate to a U.S. person, even of assets not owned at expatriation, even of post-expatriation appreciation, and even if the recipient was not a U.S. person (or even alive) at the time of the expatriation. Thus, it effectively taints a covered expatriate for life, as post-expatriation earnings and assets are subject to this inheritance tax regime.
- It is more expensive than the gift tax because it is ''inclusive.'' For example, a donor has $1.4 million available to gift. If gift tax applies, the donor could make a gift of $1 million and pay $400,000 of gift tax; the recipient receives $1 million free and clear of further federal transfer taxes. Under §2035, the gift tax paid would be excluded from the donor's estate (and thus would not attract estate tax) if the donor survives for at least three years after making the gift. But if the gift is from a covered expatriate to a U.S. person, gift tax does not apply. Rather, on a $1.4 million gift the recipient owes inheritance tax of $560,000 and has only $840,000 after transfer taxes. Thus, because inheritance tax rather than gift tax applies, the net gift is reduced by over 15%.
- The inheritance tax is reduced by applicable foreign gift or estate tax under §2801(d), which may mitigate double taxation of the transfer.
- A transfer otherwise subject to U.S. gift or estate tax is exempted by §2801(e)(2), provided that it is reported on a ''timely filed'' U.S. gift or estate tax return. This exemption may create planning possibilities: a covered expatriate may make a gift of U.S. situs property to intentionally attract U.S. gift tax, in order to exempt the gift from the inheritance tax. This exemption also highlights one of the disproportionately harsh aspects of the anti-expatriation rules: by failing to file a ''timely'' return, a gift or devise of a U.S. situs asset will generally attract double U.S. taxation (gift/estate tax on the donor, and inheritance tax on the donee).
- Certain transfers to a spouse or charity are excluded from this tax by §2801(e)(3). The exclusion is only relevant to a transfer to a U.S. spouse, as a non-U.S. spouse is not subject to the inheritance tax. What if, however, the non-U.S. spouse subsequently transfers the asset (or the proceeds from the asset) to U.S. persons, such as the children of the covered expatriate? Is this an ''indirect'' transfer from a covered expatriate that, under §2801(e)(1) (''direct or indirect'' transfers), subjects the recipients to the inheritance tax? If so, how should the indirect gift be traced?

[6] *See* Campbell and Stegman, ''Confronting the New Expatriation Tax: Advice for the U.S. Green Card Holder,'' *ACTEC Journal*, Vol. 35, No. 3 (2009).

[7] This as well as other potential overreaching in the Notice are discussed in Rubin, ''IRS Expatriation Guidance Is Helpful, but Also Overreaches,'' 39 *Tax Mgmt. Int'l J.* 3 (Jan. 2010).

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- By temporarily becoming a U.S. resident, a covered expatriate would appear to be able to make gifts of non-U.S. situs assets to U.S. persons without attracting U.S. gift or inheritance tax. That is, under §877A(g)(1)(C) and §2801(f), while a person is subject to tax as ''a citizen or resident of the United States'' they are not treated as a covered expatriate for purposes of, among other things, applying the inheritance tax. For this purpose, ''resident'' appears to be defined under §7701(b), which applies ''for purposes of this title (other than subtitle B),'' and generally includes a person spending 183 or more days in the United States during a taxable year. Furthermore, if such a covered expatriate retains a foreign domicile, he should not be considered a ''resident'' for U.S. gift tax purposes and thus, under §§2501(a)(1) and (2) and 2511(a), should not be subject to U.S. gift tax for gifts of non-U.S. situs assets.

COULD YOU BE TAXED TWICE?

The United States taxes a covered expatriate on a mark-to-market basis. The covered expatriate's country of residence may tax the same profit again, when the expatriate sells assets, receives deferred compensation, etc. Full or partial relief from double taxation may be obtained through an exemption or tax credit granted by the country of residence. However, such relief may not be available for a variety of reasons, in particular if the United States and the country of residence impose tax on the same profits but in different years (which may occur, as the U.S. tax is imposed on a mark-to-market basis rather than on a sale or other realization event). Thus, there is a significant double tax risk if the expatriate resides in a non-tax haven following expatriation.

Planning solutions here will largely depend on the nature of the assets and the tax laws of the covered expatriate's country of residence. For example, it may be possible for the covered expatriate to sell and repurchase liquid assets in the year of expatriation to get a stepped-up tax basis or potentially a credit for U.S. taxes paid.

DO YOU OWN A HOME?

In general, under §121, up to $250,000 of gain from the sale of a primary residence ($500,000 for married couples) is excluded from taxable income. It is not clear whether this exclusion applies to gain realized due to the application of the mark-to-market tax. A covered expatriate should consider selling his home before expatriating, in which case this exclusion would apply.

DOES SOMEONE OWE YOU MONEY?

The interaction of the covered expatriate and deferred compensation rules may be complex. Depending on the form of the covered expatriate's deferred compensation, it may be taxed at expatriation and/or when paid. For example:

- Tax is imposed at expatriation under §877A(e) with respect to IRAs and certain other tax-deferred accounts. The amount subject to tax generally should be the account balance as of the date of expatriation, under Notice 2009-45, §6.
- Tax is imposed at expatriation under §877A(d), in general, with respect to deferred compensation owed by a non-U.S. person. Under Notice 2009-45, §5(B), this tax applies even if the deferred compensation is not vested, e.g., would be forfeited if the covered expatriate ceased to perform services for the obligor. The amount subject to tax is generally based on the ''present value'' of the deferred compensation, but under Notice 2009-45, §5(D), the rules for computing present value vary significantly depending on the form of the deferred compensation. For example, the present value of a ''cash deferral'' (i.e., an unfunded and unsecured promise to pay money or other compensation in the future) is ''determined by applying principles in Prop. Treas. Reg. section 1.409A-4'' (a complex provision), with some modifications. Nevertheless, the amount that is subject to tax should (in general) not exceed the amount owing at the time of expatriation, and this may be further reduced by a present-value discount if the amount owing is not due to be paid until a later year. Note that Notice 2009-45, §5(D), does not permit any discount for the possibility that the deferred compensation may be forfeited.
- ''Eligible deferred compensation'' is not taxed at expatriation, provided the covered expatriate notifies the payor of his status and (through Form 8854) waives treaty benefits with respect to such compensation. Instead, under §877A(d), it is subject to a 30% withholding tax as it is paid. Examples of eligible deferred compensation generally include deferred compensation owing from a U.S. person, such as under a 401(k) plan or a deferred bonus from a U.S. employer.

Thus, the treatment of different forms of deferred compensation can vary significantly even though they are otherwise viewed as comparable or very similar. For example, an IRA is taxed but a 401(k) is not, so rolling a 401(k) into an IRA before expatriating is probably a bad idea.

Note that the covered expatriate may owe additional taxes when the deferred compensation is paid. This is because the deferred compensation, to the ex-

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tent earned for the performance of services within the United States, would appear to be effectively connected income subject to tax under §871(b). For non-eligible deferred compensation, the amount taxed at payment takes into account the amount taxed at expatriation, under §877A(d)(2)(C) and (e)(1)(C) (as further interpreted by Notice 2009-85, §5(D)). For eligible deferred compensation, under §877A(d)(6)(B) the covered expatriate will owe taxes (if any) to the extent that they exceed the amount withheld.

Further, variations in the legal form of deferred compensation can lead to significant variations in results. For example, the investment manager to a non-U.S. hedge fund may be owed deferred fees from the fund in a variety of forms. Consider the following examples:

- *Example 1.* The fund owes the fees to the manager personally. The manager is taxed on the deferred fee at expatriation, as ordinary income. When the deferred fees are actually paid, the manager should only be taxed on any amount in excess of what was previously taxed.
- *Example 2.* The fund owes the fees to a management company that is a domestic partnership largely owned by the manager. Mark-to-market rather than the deferred compensation rules should apply, because the manager is not (directly) owed deferred compensation. Section 751 appears to cause any gain realized to be taxed as ordinary income. So far, this result is similar to Example 1. However, whereas the amount subject to tax in Example 1 would be based on the present value of the deferred fees (as determined under §409A principles), the amount subject to tax in Example 2 is based on the fair market value of the manager's interest in the management company (as determined under estate tax principles). When the deferred fee is actually paid, the manager should (under the principles of §877A(a)) only be taxed on amounts in excess of what was previously taxed, but it is not entirely clear whether this result is obtained. To the extent that the manager is double-taxed, the manager will have a capital loss in the management company that is most likely worthless.
- *Example 3.* The fund owes the fees to a management company that is an S corporation largely or entirely owned by the manager. The result may vary significantly from examples 1 and 2. Mark-to-market rather than the deferred compensation rules should apply, because the manager is not (directly) owed deferred compensation. However, the mark-to-market gain would appear to be capital gain because there is no corollary to §751 for an S corporation. However, under §1361(b)(1)(C) the manager's expatriation would likely require the management company to convert to a C corporation and, because under §448 a C corporation generally cannot use the cash method of accounting, the management company would concurrently be subject to corporate income tax on the deferred fee. This is a bad result, and such a structure requires pre-expatriation planning.
- *Example 4.* The fund owes the fees to such a management company, and the management company in turn owes the fees to the manager. This creates additional levels of complexity, beyond the prior examples.

Query whether deferred compensation counts toward the net worth test for covered expatriate status.

DOES EXPATRIATING END YOUR U.S. TAX OBLIGATIONS?

It may or may not. An expatriate with no connection to the United States subsequent to expatriation should have no subsequent U.S. tax obligations.

The act of expatriating itself creates tax obligations, some of which are discussed above. In addition, every expatriate, covered or not, is required to file Form 8854 with his (potentially final) Form 1040. Form 8854 may not be easy to complete. Among other things, it requires a detailed balance sheet reporting the fair market value and tax basis of all the expatriate's assets, separated into 19 different categories. This represents a singular compliance burden.

However, expatriates may continue to have other U.S. tax obligations, including:

- Filing form 1040-NR to report and pay tax on any U.S.-source income that was not paid through withholding, as well as any U.S. effectively connected income (such as deferred compensation payments). A nonresident alien not engaged in a U.S. trade or business is not required to file a U.S. tax return if his U.S. tax liability is satisfied through withholding. Regs. §1.6012-1(b)(2).
- Replacing U.S. withholding certificates (such as replacing the Form W-9 filed with brokers, investment advisors, etc., with Form W-8 BEN). Failure to do so may lead to underwithholding of U.S. tax, such as on U.S.-source dividends, requiring the expatriate to file a U.S. tax return and pay any deficiency.
- Form W-8CE should be filed with the payor of any deferred compensation item, such as an IRA custodian, 401(k) administrator, or obligor of any other form of deferred compensation.

CONCLUSION

Expatriation can raise numerous complex U.S. income and transfer tax issues. These issues may re-

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quire continuous U.S. tax planning — from before the act of expatriation through (and even after) the expatriate's death. By highlighting a few particular issues, this article is intended to help move past the general features of the anti-expatriation rules and focus on specific problems their clients may face and some planning techniques to deal with them.

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