EXPATRIATION THE TRANSATLANTIC WAY: OVERVIEW OF THE FRENCH AND THE U.S. REGIMES

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Over the past years, both France and the United States recorded a growing number of individuals expatriating as a tax planning device.

In order to discourage the tax exiles, the French government introduced an exit tax in the late 90's.[1] It called for the immediate taxation of unrealized capital gains on shares that represent at least 25% of the share capital of a company held by the expatriating individual. In comparison to U.S. rules, an individual was caught by the French expatriation tax upon the relinquishment of tax residence rather than citizenship. Thus, the threshold for the tax was much lower than in the U.S. The law was intended to limit the temporary exile of entrepreneurs willing to sell their shares in more favorable tax conditions than under French tax law. Belgium could be seen, for French taxpayers, as a “tax vacation” destination; by becoming a Belgian resident, a French taxpayer could sell French shares without paying any tax either in France or in Belgium.

However, the Court of Justice of the European Union (formerly European Court of Justice) invalidated the French exit tax regime because it violated the principle of freedom of establishment (article 43 of the treaty establishing the European Community).[2] Pursuant to this decision, article 167 bis of the French Tax Code was abolished as of January 1, 2005.

The 2008 crisis affected the economies of many States, including France, and resulted in increased tax burdens for resident individuals. In 2007 for instance, gains realized by individuals on the sale of securities were taxed at the rate of 16% plus an 11% social contribution, resulting in an overall tax burden of 27%. Today, the same gains are taxed at the French progressive income tax of up to 45% plus an exceptional contribution on high income of 4% after possible allowances based on the holding period for certain securities. The gains are also subject to an added 15.5% social contribution, resulting in a potential tax of more than 60% on some or most of the gain realized.

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[1] Late Section 167, 1 bis and Section 167 bis of the French Tax Code (Section 24 of the Financial Law for 1999).

[2] European Court of Justice, Lasteyrie du Saillant, March 11, 2004, case C-9/02, 5e ch.

As a result, many French tax residents were incentivized, again, to take "tax vacations" in countries offering a "less confiscatory" tax system. This, in turn, led to the rebirth of the French exit tax in the form of the Amended Finance Law for 2011.[3]

Like France, the U.S. is no longer a tax paradise. It, also, introduced an exit tax. Prior to 2008, expatriate individuals were subject to U.S. tax on certain income that was deemed to arise from U.S. sources for a period of ten years following the date "H.E.A.R.T. Act") modified the then existing expatriation regime. The current regime applies to individuals expatriating on or after June 17, 2008 for both income tax and succession tax purposes. Note that mere relinquishment of tax residence is not sufficient to trigger application of the expatriation tax in the U.S., other than for non-citizens who hold green cards for eight or more years within a 15-year period. Because the U.S. imposes tax on citizens residing outside the country, relinquishment of U.S. citizenship is the trigger for the tax.

This article aims to compare the French and American exit tax regimes by giving an overview of their respective scopes and effects. The U.S. succession tax is not covered by this article. That is a special inheritance tax paid by the recipients of gifts and bequests from an expatriate that is covered by the expatriation tax.

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THE SCOPE OF THE FRENCH AND U.S. EXIT TAX REGIMES

The scope of the French and U.S. exit taxes are quite different. In France, the exit tax regime was introduced to limit the tax benefit derived by individuals looking to avoid tax on certain capital gains. The scope is consequently limited to these assets. In the United States the objective is broader, and therefore, the scope is wider.

In France

As previously mentioned, the first Amended Finance Act for 2011 dated July 29, 2011 reintroduced the exit tax regime in France. The exit tax is codified under article 167 bis of the French Tax Code. The 2013 Amending Finance Act broadened the scope of this tax regime.[4]

This new exit tax on unrealized capital gains[5] applies retroactively to March 3, 2011 and covers individuals who transferred tax residence after that date.

Under the 2011 regime, the exit tax applied only to taxpayers who were French tax residents during at least six of the ten years preceding the transfer of residence to outside of France. The exit tax applied to the following unrealized or deferred gains:

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3 Law n°2011-900 of July 29th, 2011.

4 Section 42 of the 2013 Amending Finance Act, n° 2013-1279, dated December 29, 2013. Indeed, on December 31, 2013, there were only 251 exit tax returns.

5 Valued on the day preceding the date of departure.

- Unrealized capital gains relating to securities that represent at least 1% of the share capital of a company, or to direct or indirect shareholding with a value of more than €1.3 million, corresponding to the wealth tax threshold;

- Previously realized capital gains on shares for which taxation was deferred under French tax law, such as the realized but untaxed gain when a taxpayer contributes shares to a company; and

- Amounts payable under an "earn-out" provision.

The 2013 Amending Finance Law introduces a number of changes to the French exit tax regime:

- The 1% shareholding threshold is replaced with a 50% threshold in order to only target majority shareholding;

- Alternatively, a shareholding that has a value in excess of €800,000;

- Certain investment funds[6] that were outside the scope of the exit tax are now taxable on the same basis as other securities.

Several investments remain outside the scope of the exit tax. Most prominently, the exit tax does not apply to shares of real estate companies. These are companies in which 50% or more of the assets directly or indirectly consist of real estate not used in the company's principal trade or business.

Pre-expatriation planning is thus available to French expatriates.

In the U.S.

Section 877A of the Internal Revenue Code of 1986 (the "Code"), as currently in effect, applies to certain U.S. citizens relinquishing citizenship and certain long-term residents who cease to be green card holders.[7] These two categories of individuals are referred to as "Expatriates."[8] For this purpose, a "long-term resident" is an individual who held a green card for at least eight years out of a 15 taxable-year period ending with the year of the expatriation.[9]

Persons becoming Expatriates are subject to the exit tax if they meet the following requirements:[10]

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6 The French "Organisme de placement collectif en valeurs mobilières."

7 Within the meaning of Section 7701(b)(6) of the Code.

8 Section 877A(g)(2) of the Code.

9 Any taxable year during which a U.S. green card holder is treated as a resident of another country (pursuant to the tie-breaker rules contained in an applicable income tax treaty with the U.S.) generally is not considered a year in which the individual holds a green card for purposes of the above computation. Section 877(e)(2) of the Code.

10 Section 877A(g)(1) of the Code.

- The average net income tax liability of the Expatriate during the five taxable-year period ending prior to the date of expatriation exceeds a certain amount that increases with inflation. Currently, that amount is $157,000[11] (the "Income Tax Liability Test"). This test looks to income taxes owed in the U.S. after taking into account the foreign tax credit and certain other credits;

- The Expatriate's net worth at the expatriation date is equal to at least $2,000,000 (the "Net Worth Test"); or

- The Expatriate did not file Form 8854 ("Initial and Annual Expatriation Statement") declaring under penalties of perjury that the Expatriate complied with all U.S. income tax laws during the five taxable years preceding the year of the expatriation (the "Certification Test").

For purposes of the exit tax, Expatriates meeting the above requirements are "covered expatriates." For U.S. citizens, the expatriation date is the date on which the individual gives up U.S. citizenship. For long-term residents of the U.S., the expatriation date is the date on which they cease to be green card holders.

Several exceptions exist for the Income Tax Liability Test and the Net Worth Test. Under one of the exceptions, neither test is met if, at birth, the Expatriate was a citizen of the U.S. and of another country, continues to be a citizen and resident of that other country, and has been a resident of the U.S. for not more than ten taxable years out of the 15 taxable-year period ending with the year of expatriation.

Another exception applies to a U.S. citizen who relinquishes U.S. citizenship before the age of 18½ years, provided that individual was not a resident of the U.S. for more than ten taxable years prior to the date of expatriation.

Here again, pre-expatriation planning is available to U.S. Expatriates.

THE CONSEQUENCES OF THE FRENCH AND THE U.S. EXIT TAX REGIMES

In France

When the French exit tax is applicable, the built-in capital gains on securities are immediately taxed. The basis of the tax assessment is the difference between the fair market value of the securities at the date of the exit and the purchase price by the taxpayer.

The capital gains so calculated are subjected to the progressive French individual income tax rates, allowances, and social contributions discussed above.[12]

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[11] Rev. Proc. 2013-35

[12] The taxable basis of the exit tax is calculated based on the new capital gains regime, taking into account new allowances provided by the Article 150-0 D of

FRENCH INCOME TAX SCALE IN 2014	
Until €6,011	0%
From €6,011 to €11,991	5.5%
From €11,991 to €26,631	14%
From €26,631 to €71,397	30%
From €71,397 to €151,200	41%
Beyond €151,200	45%

However, an automatic tax deferral will be granted to taxpayers who transfer their tax residence to another European Union ("E.U.") member state or to a European Economic Area ("E.E.A.") member state that has entered into an administrative assistance agreement with France to combat fraud and tax evasion, and a mutual assistance agreement for the collection of taxes.

For transfers to other countries, tax deferral may be granted upon a specific request by a taxpayer who offers guarantees for payment of the deferred tax[13] and designates a tax representative in France.

Deferral without guarantees may be granted if the individual demonstrates that the transfer of tax residence is due to a professional purpose such as a business transfer by a multinational employer. Deferral may also be available for transfers to a state that is not part of the E.E.A., if certain conditions are met.

If not paid at the date of the transfer, the tax will be due to the French Tax Authorities in case of transfer, repurchase, repayment or cancellation of the securities.[14] The taxable event is the date of departure and not the date of sale. This is aimed at allowing France to tax the gain even if the individual has moved to a country that has in effect a tax treaty with France that allocates the right to tax capital gains from the sale of securities to the country of residence. In order to prevent double taxation, the taxpayer may benefit in France from a tax credit for the tax paid in the residence state on an actual gain.

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the French tax code (*e.g.*, by taking into account a 50% rebate after a two-year holding period and 65% after eight years). The rebate can go up to 85% under certain condition.

13 This guarantee is calculated on 30% of the amount of unrealized capital gains.

14 The Law clarifies the rules for offsetting capital losses from sales of securities subject to the exit tax (post-departure) against capital gains on other securities. Lastly, the Law clarifies how the contribution of shares realized after the transfer of tax residence should be treated, by providing that contributions realized pursuant to Article 150-0 B ter of the French tax code do not have the same consequences as "sales," which put an end to the deferral of payment of the exit tax. The deferral of payment of the exit tax applies until the date of sale of shares received in exchange for the contribution or of the contributed shares within three years of the contribution, except reinvestment within the deadlines provided by Article 150-0 B ter of the French tax code.

The exit tax on unrealized capital gains may be waived or refunded in several cases:

- No triggering event occurs in the 15 years following the departure of the taxpayer. Prior to the 2013 Amending Finance Law, the triggering period was eight years, with the waiver or refund applied to only the income tax.
- The taxpayer moves his/her residence back to France within the 15 year period;
- The taxpayer dies;
- The taxpayer gifts the shares.

Regarding gifts, the initial bill required the taxpayer to demonstrate intent to donate as the principal purpose for the gift. The 2013 Amending Finance Law eliminated the purpose requirement which was ruled as contrary to E.U. law by the French Administrative Supreme Court on July 12, 2013, n°359994 for taxpayers who become residents of the E.U. or of the E.E.A. Taxpayers moving to other countries remain obligated to prove that the "main" reason for the gift was not the avoidance of the exit tax.

Tax planning is consequently still available "through expatriation followed by gifts." However, the country of expatriation should be well chosen in order for the gift not to be taxed in France.

In the U.S.

Under Section 877A of the Code, all of the property of a covered expatriate is treated as subject to a deemed fair market value sale occurring on the day immediately preceding the date of expatriation. Any deemed realized gain or loss must be taken into account in the taxable year of the deemed sale, after reduction of an amount of $663,000.[15] Particular attention must be paid when a domestic trust becomes a foreign trust due to the expatriation of the taxpayer. In that case, the application of the mark-to-market rule of Section 684 of the Code trumps the application of Section 877A, and the Expatriate cannot benefit from the $663,000 *de minimis* exemption.[16] If the Expatriate is a long-term resident of the U.S., gain is computed by taking into account a stepped-up basis as of the residency. Certain items of property are excluded from the deemed mark-to-market sale rule, generally dealing with deferred compensation and interests in trusts.[17]

An Expatriate can elect to defer the payment of the exit tax. This election is made on a property-by-property basis. It must be secured by an acceptable arrangement

[15] Section 877A(3) of the Code, as adjusted for inflation for tax year 2013.

[16] Sections 877A(h)(3) and 684 of the Code.

[17] Certain deferred compensation items (see Section 877A(d) of the Code), certain specified tax deferred accounts (see Section 877A(e) of the Code) and certain distributions of property from a nongrantor trust to a covered expatriate (see section 877A(f) of the Code).

with the I.R.S.[18] and is irrevocable.[19] In addition, the taxpayer making the election must waive all claims to the benefits of an income tax treaty that may reduce his or her liability to the exit tax.[20]

The payment of the tax is deferred until the occurrence of the earliest of the following events:

- The due date of the return for the taxable year in which the actual sale of the property occurs or if the property is disposed of in a nonrecognition transaction (*e.g.*, a gift), until such other date as provided by the I.R.S.;
- The due date of the return for the taxable year of the individual's death; or
- The time that the security provided by the individual fails to meet the appropriate requirements.[21]

"Although the deferred payment of the tax is allowed, underpayment interest runs on the amount of tax deferred. The interest runs from the original due date for the payment of the exit tax."

Although the deferred payment of the tax is allowed, underpayment interest runs on the amount of tax deferred. The interest runs from the original due date for the payment of the exit tax.[22]

Absent the issuance of income tax regulations under Section 877A of the Code, the I.R.S. published Notice 2009-35. Under this notice, an Expatriate is required to file Form 8854 along with a dual-status return in the tax year of Expatriation. A dual-status return requires the filing of Form 1040NR ("U.S. Nonresident Alien Income Tax Return") to which is attached Form 1040 ("U.S. Individual Income Tax Return") in regard to the portion of the tax year that preceded the date of expatriation. In the case of an expatriation date on January 1 of a given year, no dual-status tax return must be filed. In subsequent years, the covered expatriate must file Form 1040NR in the event that effectively connected income or U.S. source fixed or determinable, annual or periodic income is realized. For covered expatriates electing for the deferral of tax, Form 8854 must be filed every year up until the year of the payment of the entire exit tax and interest.

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18 Section 877A(b)(4) of the Code.
19 Section 877A(b)(6) of the Code.
20 Section 877A(b)(5) of the Code.
21 Section 877A(b)(1) and Section 877A(b)(3) of the Code.
22 Section 877A(b)(7) of the Code.

A COMPARATIVE TABLE OF THE FRENCH AND THE U.S. EXIT TAX REGIMES

Comparative Table		
	France	**U.S.**
Triggering Event	Transfer of tax residence	Giving up citizenship / ceasing to be a green card holder
Properties Subject to Exit Tax	Corporate Securities	All property
Exceptions / Tax deferral	Tax Deferral: - Taxpayers who transfer tax residence to another E.U. member state or to a cooperating E.E.A. member state. - For transfers to other countries: upon a specific request by the taxpayer if guarantees are offered for the tax deferred and a tax representative in France is designated. - Upon the taxpayer's request if justifies demonstration is made that tax residency was transfer for business reasons.	Exceptions: - Certain dual birth citizens and certain citizens prior to age 18½. Tax Deferral: - Upon election - On a property-by-property basis - Irrevocable - Security requirement must be met - Waiver of treaty benefits - Reporting and filing requirements must be respected - Interest applies despite deferral
Highest Applicable National Tax Rate	45% (income tax) + 4% (exceptional contribution tax on high income) + 15.5% (social contributions) = 64.5%	20% in the case of capital gains or 39.6% absent capital gains + Additional Potential 3.8% Net Investment Income Tax (+ applicable state and local taxes)

CONCLUSION

For both U.S. and French purposes, the exit tax constitutes an important element in determining whether or not to expatriate. In both countries, the advice of competent tax counsel should be sought prior to expatriation in order to manage the consequences of this tax.