PRE-IMMIGRATION INCOME TAX PLANNING, PART II: COVERED EXPATRIATES

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INTRODUCTION

Continuing on from our previous article concerning pre-immigration planning, this article will explain the tax rules by which an individual seeking to renounce his or her U.S. citizenship or green card status may be affected.

To relinquish U.S. citizenship or a green card, a formal act of relinquishment is required. Therefore, a green card holder who moves outside the U.S. will continue to be treated as a U.S. resident for tax purposes until he or she formally relinquishes green card status or it is rescinded by the government. A U.S. citizen residing outside the U.S. will have to formally relinquish his or her citizenship in order to be removed from the U.S. tax system. As a general rule, termination of U.S. residency becomes effective on the last day of the calendar year in which the status was relinquished. However, under certain circumstances, termination may be effective midyear.

Upon expatriation, should an individual be considered a "covered expatriate," he or she may be subject to an exit tax, and following expatriation, any gifts and bequests made by such an individual may be subject to a succession tax in the case of U.S.-resident recipients.[1]

For planning purposes, U.S. citizens wishing to relinquish their citizenship should determine if they are covered expatriates prior to undertaking any such action. Green card holders wishing to relinquish green card status must first determine if they are treated as long-term residents. If so treated, green card holders should determine if they are covered expatriates under the same tests applicable to U.S. citizens.

COVERED EXPATRIATES

An individual will be treated as a covered expatriate if, at the time of expatriation, he or she meets any one of three tests:

1. The individual's average annual net U.S. income tax liability for the last five years exceeds $160,000[2] (the "Tax Liability Test");
2. The individual has a net worth of $2,000,000 or more (the "Net Worth Test");
3. The individual fails to certify under penalties of perjury, or if required, fails to submit evidence of, compliance with all U.S. Federal tax laws for the last five years.[3]

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[1] As with our prior installment, this article addresses U.S. taxing obligations; departure taxes in other countries are beyond the scope of this article.

[2] Amount applies to 2015 and is adjusted for inflation.

[3] Such certification is made on I.R.S. Form 8854.

For purposes of the Net Worth Test, all types of property are taken into account (*i.e.*, real property, tangible personal property, and intangible property, including, and without limitation, checking accounts and money or other goods in safety deposit boxes). No formal appraisal is required, but the valuation should be made based on the general principals provided in the Internal Revenue Code (the "Code") and Treasury Regulations.

Due to the third test, certain individuals whose net worth is insufficient and their income is also not high enough might nevertheless be treated as covered expatriates. Think of a non-citizen who moved to the U.S. and never reported a foreign financial account he left behind, to name only one type of individual who may face the expatriation tax solely because of the third test. Such individuals may want to consider straightening out their affairs, be it through the I.R.S.'s offshore voluntary program or otherwise, prior to relinquishing residency.

Exceptions Applicable to U.S. Citizens

A child who relinquishes U.S. citizenship will not be treated as a covered expatriate, regardless of the aforementioned tests, provided that (i) citizenship is relinquished before the age of 18½ years, and (ii) he or she has never been a U.S. resident, or having been a U.S. resident, was resident under the substantial presence test for not more than ten taxable years prior to such relinquishment.[4]

A dual citizen, who has been a U.S. resident under the substantial presence test for no more than ten of the last 15 taxable years, will not be subject to the covered expatriate rules if (i) he or she became a dual citizen of the U.S. and another country at birth, (ii) he or she will continue to be a citizen of that foreign country after relinquishing U.S. citizenship, and (iii) that foreign country would tax him or her as a resident.

Example 1:

Jane was born in Toronto. Her parents are U.S. citizens, and she obtains U.S. citizenship through them. Jane is also a Canadian citizen by birth. She has never resided in the U.S. Jane can expatriate before reaching the age of 18½ years without regard to the covered expatriate tests.

Example 2:

Jane was born in the U.S. to two non-U.S. nationals residing in the U.S. for graduate studies. Jane was born 1995 and is a U.S. citizen by birth. Her parents' country of nationality treats children of nationals as citizens. In 2010, her family moves to her parents' home country, and since that time, Jane was not present in the U.S. for more than 30 days per year. At any point starting in 2015, Jane can relinquish her U.S. citizenship without regard to the covered expatriation tests because as of January 1, 2015, out of the last 15 years she would be a U.S. resident under the presence test for no more than ten years.

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[4] A minor less than 14 years of age cannot renounce U.S. citizenship, and a child's U.S. citizenship cannot be renounced by a parent.

LONG-TERM RESIDENCY

The expatriation rules will apply to non-citizens if they have a green card for long enough to be treated a long-term resident. A green card holder will be treated as a long-term resident if he or she holds a green card for at least eight of the last 15 taxable years. When determining the eight years, any day of holding a green card during a calendar year can cause the entire year to count as a full year. However, some days may be excluded from the count. If the tie-breaker provision of an applicable income tax treaty allocates residency away from the U.S., days during such a period of time will not count toward the eight years if the individual claimed such a treaty benefit.[5]

"Under current law, covered expatriates are subject to an exit tax, pursuant to which the individual is generally deemed to have sold all property, regardless of location, on the day before he or she relinquished U.S. citizenship or long-term resident status."

> Example 3:
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> John received his green card on December 1, 2010. John will be treated as a long-term resident on January 1, 2017 (less than seven years after the date he received his green card).
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> Example 4:
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> John received his green card on December 1, 2010. In March 2014, John moves back to his country of nationality without relinquishing his green card. John files his 2014 tax return as a non-resident under an income tax treaty between the U.S. and his country of nationality. In April 2020, John moves back to the U.S. On January 1, 2023, John will be treated as a long-term resident (more than ten years after the date he received his green card).

TAXATION OF COVERED EXPATRIATES

If an individual is treated as a covered expatriate, the individual must file Form 8854, Initial and Annual Expatriation Statement. This form should be included with the individual's tax return for the year of expatriation. Failure to file (or filing an incorrect form) incurs a $10,000 penalty. The penalty may be waived if it is shown that the failure was due to reasonable cause and not to willful neglect.

Two sets of tax rules govern covered expatriates. The first, which applies directly to the covered expatriate individual, is found in Code §877A. The second, found in Code §2801, applies to the recipient of gifts or bequests made by covered expatriates.

Rules Applicable to the Covered Expatriate

Prior to June 2008, expatriates remained subject to U.S. taxation on various types of U.S.-source income for ten years but otherwise, generally, had no immediate tax consequences. Under current law, covered expatriates are subject to an exit tax, pursuant to which the individual is generally deemed to have sold all property, regardless of location, on the day before he or she relinquished U.S. citizenship

[5] The Code and its regulations provide that claiming such a treaty benefit may affect the immigration status for such an individual. See Code §§877A(g)(5) and 877(e)(2), Treas. Regs. §301.7701(b)-7(a)(1).

or long-term resident status. This set of rules is known as the "mark-to-market" rule. The property subject to this deemed sale is generally any property that would be included in the taxpayer's gross estate for estate tax purposes if the taxpayer died that day as a citizen or resident of the U.S. Gain or loss is recognized on the deemed sale, and tax is due. For 2015, the net gain is reduced (not below zero) by $690,000.[6] Therefore, only covered expatriates that have more than $690,000 of net appreciation in their worldwide property will have an exit tax liability.

For purposes of determining the gain or loss recognized, if property was acquired prior to the individual becoming a U.S. resident, the basis for the deemed sale of that property will be the greater of (i) the fair market value at the time U.S. residency was first established or (ii) the adjusted basis under general U.S. tax principles, subject to an irrevocable election made on a property-by-property basis. Notwithstanding the aforementioned, no step-up in basis is applied to assets that will give rise to U.S. tax regardless of U.S. residency. For example, U.S. real property interests and property used or held for use in connection with the conduct of a U.S. trade or business are subject to U.S. taxation of non-residents and, thus, do not receive a step-up in basis. However, upon actual sale, such assets will only be subject to U.S. tax if the value has increased since the time of the deemed sale because any recognized gain will increase the basis of such property.[7]

Tax basis of the property subject to the exit tax will be adjusted by the amount of gain or loss recognized.

The exit tax applies to real property interest, albeit that the individual would not have escaped the tax net, as non-residents are also taxed on real property situated in the U.S. The exit tax, however, does not apply to deferred compensation items and specified tax-deferred accounts. Such items include, *inter alia*, individual retirement plans, 401(k) plans, and stock options or restricted stock on which an election under Code §83(b) has not been made.

A covered expatriate who has an interest in a deferred compensation item or a specified tax-deferred account must file Form W-8CE, Notice of Expatriation and Waiver of Treaty Benefits, within 30 days of expatriation or on the day prior to a distribution, if earlier, to provide the payor with notice that the individual is a covered expatriate and thereby advise the payor of its withholding tax obligation.

A covered expatriate may elect, on a property-by-property basis, to defer the payment of tax due upon the deemed sale at expatriation until the year in which the asset is actually sold. However, the deferred tax will be subject to interest applicable to underpayments of tax, and the expatriate must (i) irrevocably waive any treaty benefits with respect to the collection of tax on such property, (ii) enter into a tax-deferral agreement with the I.R.S., and (iii) provide adequate security. A covered expatriate may pay the deferred tax, together with accrued interest, at any time before it becomes due.[8]

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[6] Amount adjusted for inflation.

[7] Note that if gain is recognized at the time of sale, such gain will be subject to Code §897 and a 10% F.I.R.P.T.A. withholding tax will be collected by the buyer.

[8] If the expatriate dies before paying all of the deferred tax, the unpaid tax is payable on the due date of the expatriate's final income tax return.

Rules Applicable to the Recipient of Gifts or Bequests

Under Code §2801, "covered gifts" and "covered bequests" made by a covered expatriate to a U.S. resident may be subject to tax (the "succession tax"). The succession tax applies to all covered gifts and covered bequests, regardless of when the gifted/bequeathed property was acquired by the donor/deceased. A covered gift made to a U.S. trust is subject to the succession tax as if the trust were a U.S. citizen. A covered gift made to a foreign trust is not subject to the succession tax, but distributions from such a trust to a U.S. person will be treated as covered gifts.

> Example 5:
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> John renounced his green card in 2010. His net worth at the time was $3 million. John is a covered expatriate, by virtue of the Net Worth Test. John has two children who are U.S. citizens by birth. In 2025, John purchases an apartment building outside the U.S. worth $10 million. At the conclusion of John's lifetime, his two children, who are U.S. citizens residing outside the U.S., inherit the apartment building. The bequest is a covered bequest.

Covered gifts or covered bequests that are subject to the succession tax are thereby subject to the highest applicable estate tax rate (currently 40%). The succession tax is reduced by foreign gift or estate taxes paid with respect to the transferred property (but not foreign income tax), regardless of whether it is paid by the recipient or the donor/estate.

"Covered gifts or covered bequests that are subject to the succession tax are thereby subject to the highest applicable estate tax rate (currently 40%)."

The recipient of a covered gift receives a basis in the gift that is the same as that in the hands of the donor. In general, unlike property that transfers by bequest, gifts do not provide the recipient with a step-up in basis, regardless of the expatriation rules. Unlike the mark-to-market rules, with respect to the succession tax, there is no provision in the Code that provides for a step up in basis for the tax paid.

The I.R.S. announced in 2009 that reporting and tax obligations relating to the succession tax are deferred pending issuance of guidance and a new Form 708.[9] As of the date of this article, no guidance has yet been published.

Exceptions

Transfers Subject to U.S. Gift or Estate Tax

If a covered expatriate is subject to gift or estate tax with respect to the property, no succession tax will apply to the recipient, provided that a timely gift tax return or estate tax return is filed.

> Example 6:
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> The same facts apply as in Example 5, but John's apartment building is now located in the U.S. Since the gross estate of a non-resident includes U.S. real property holdings, the bequest will not be a covered bequest.

[9] I.R.S. Announcement 2009-57.

Spousal Gifts and Bequests and Charitable Giving

Succession tax is generally not imposed on gifts and bequests to a U.S. spouse or a U.S. charity.

Annual Exclusion

A gift by a covered expatriate is not a covered gift until it exceeds the annual gift tax exclusion. The annual gift tax exclusion for 2015 is $14,000.

Additional Compliance

Covered expatriates should remember to file new withholding certificates with any payor to replace those reflecting U.S. residency status. Consequently, a Form W-9 previously filed with brokers, investment advisers, and banks must be replaced with Form W-8BEN.

CONCLUSION

Due to the complexity and the graveness of taxation of both expatriates and U.S.-resident recipients of covered gifts and bequests, proper planning is necessary prior to expatriation. Such planning can minimize the total amount of taxes due and, depending on the facts, may even preclude covered expatriate status.

Part III of this series will present various planning opportunities to limit application of the expatriation tax rules.