PRE-IMMIGRATION TAX PLANNING, PART III: REMEDYING THE ADVERSE CONSEQUENCES OF THE COVERED EXPATRIATE REGIME

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INTRODUCTION

Following our previous articles regarding pre-immigration planning and the expatriation rules applicable to covered expatriates (see here and here), this article considers some techniques for implementation before and after expatriation, with the objective to reduce the adverse treatment of the covered expatriate regime to the extent possible depending on the specific facts and circumstances of each individual.[1]

For a Green Card holder, expatriating prior to becoming a long-term resident would eliminate the application of the covered expatriate regime. For a U.S. citizen (other than children under certain situations), the circumstances that will allow for a tax-free expatriation are more restrictive. An individual is considered a covered expatriate if he or she meets one of three tests.[2] Pre-expatriation planning can eliminate the application of the covered expatriate regime for some individuals, while for others additional planning may be needed to reduce the unfavorable effect of the covered expatriate rules.

PRE-EXPATRIATION PLANNING

- If an individual is deemed to be a covered expatriate solely because his net worth is valued over $2.00 million, the individual should consider making transfers prior to the expatriation date to reduce his net worth to below $2.00 million. The individual can transfer an amount up to $5.43 million (the lifetime exemption amount) without incurring gift tax liability and in principle, these gifts should be of highly appreciated non-U.S. assets.[3]
- An individual whose net worth exceeds $7.54 million in 2015 (and adjusted as the lifetime exemption changes from year to year) should consider making taxable gift transfers prior to the expatriation date to reduce the mark-to-market exit tax liability and the succession tax liability.

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1 As with our prior articles, this article addresses U.S. taxing obligations; departure taxes in other countries are beyond the scope of this article. Additionally, the article assumes children of covered expatriates are U.S. persons in their own right so that gifts and bequests made after expatriation will be subject to the succession tax if not for suggested planning.

2 See our previous edition of Insights here, p. 54

3 This amount reflects the lifetime estate/tax gift tax exemption for 2015. It will be adjusted for inflation in the future. A married couple can transfer an amount up to $10.48 million.

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- ○ If gifts are made prior to expatriation, the out-of-pocket cost of making a gift of a specific sum of money is significantly less under the gift tax imposed on the donor than under the succession tax imposed on the recipient. While both taxes are levied at a rate of 40%, the gift tax paid by the donor is itself not subject to gift tax. In comparison, an amount paid to a U.S. individual that is subject to post expatriation succession tax is itself subject to gift tax. Compare the transfer of a gift valued at $1.00 million. The gift tax imposed on the donor who makes a gift of $1.00 million prior to expatriation is $0.40 million. The net cash out of pocket is $1.40 million of gift and tax. In comparison, the gross amount that must be given subsequent to the expatriation that allows a recipient to retain $1.00 million is $1.67 million ($1.00 million ÷ 0.6 (the amount left after tax) = $1.67 million). Of that amount, the tax is $0.67 million and the net gift is $1.00 million.

- ○ For those who are contemplating expatriation and have minor children, completed transfers of wealth could be made to an irrevocable trust for the benefit of the expatriate’s children prior to expatriation. So long as the gift is complete when made, the gift would reduce the net worth of the individual for purposes of the mark-to-market tax, the gift tax due would be less than the potential succession tax that would apply should the transfer occur after expatriation, and most importantly from a family viewpoint, the children are not given the funds outright. The expatriating individual should not be the trustee.

- A long-term resident (*viz,* an individual who holds a Green Card for eight of the last 15 taxable years) should consider acquiring foreign domicile[4] prior to formally expatriating. A foreign domiciliary may transfer an unlimited amount of non-U.S. situs assets without incurring gift tax liability. A foreign domiciliary is subject to gift tax only with respect to transfers of real and tangible property located in the U.S. Provided that gifts are made prior to the relinquishment of status as a long-term resident, such individual could reduce his net worth to below the $2.00 million threshold. This planning alternative is extremely helpful for non-citizen individuals who were present in the U.S. while holding a green card and who left the U.S. without formally relinquishing permanent resident status.

- To obtain tax planning flexibility, Green Card holders that are not yet long-term residents may consider relocating on a temporary basis to a foreign country prior to obtaining long-term resident status. The foreign country must have an income tax treaty in effect with the U.S. and the treaty must include a tiebreaker provision with respect to residency. If an individual can allocate residence to the foreign country for the relocation year and subsequent years, the eigth year of residence under the Green Card may never be reached. Of course, this strategy can have immigration law consequences. A Green Card holder who obtains a re-entry permit may be absent from the U.S. for up to two years without losing his status. The same strategy may be applicable to non-citizen individuals who were present in the U.S. while holding a Green Card and who left the U.S. without formally relinquishing

[4] The U.S. definition of domicile is defined as living within a country with no definite present intent of leaving.

permanent resident status, provided that they claim treaty benefits for tax years earlier than the eigth year in which the Green Card is held on late filed or amended tax returns.

- If a married couple filing jointly is treated as covered expatriates solely because the tax liability test is met because the joint tax return tax liability is allocated entirely to each of the individuals,[5] consideration should be given to the submission of amended tax returns reflecting a married filing separate status for prior years. While the total tax for those years may be increased, it may be possible for neither individual to exceed the tax liability threshold, which is $160,000 in 2015.

- If an individual will be treated as a covered expatriate solely because he fails to certify U.S. tax compliance for the five years preceding the year of expatriation, the individual should consider correcting past compliance issues prior to expatriating. Individuals in this set of circumstances face issues relating to the underpayment of taxes, underpayment penalties, late filing penalties, penalties related to the failure to file specific forms, and interest. However, if the the compliance failure relates to offshore financial assets and income derived from foreign financial accounts, the I.R.S. has two programs available to bring taxpayers into compliance retroactively:

    ○ The offshore voluntary disclosure program ("O.V.D.P.") that is offered to taxpayers that may be willful with respect to their delinquencies, and

    ○ The Streamlined Procedure that is offered to non-willful delinquencies.

- Covered expatriates who desire to sell their principal residence should do so prior to expatriation to take advantage of the $500,000 capital gain tax exclusion.

Post Expatriation

- Covered expatriates are not treated as such for purposes of the succession tax for years in which they are treated as U.S. residents for income tax purposes. Thus, if possible, prior to transferring a highly valuable non-U.S. asset a covered expatriate should attempt to satisfy the substantial presence test[6] so that the transfer is not considered a covered gift subject to the succession tax. If such individual remains domiciled in a foreign jurisdiction, in principle the transfer would not be subject to gift tax for reasons mentioned above.

- As a transfer below the gift tax annual exclusion is not treated as a covered gift, a covered expatriate should considering transferring an amount up to $14,000 a year, per U.S. child (or other U.S. recipient).[7] Such annual gifts

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5 *I.e.*, the average annual net U.S. tax liability for the last five years exceeds $160,000 – this amount is adjusted for inflation.

6 See Code §7701(b)(3) for the test. Generally, an individual will meet the substantial presence test if he or she is present in the U.S. for 31 days or more in the tax year, and all days present in that year, plus one third of the days present in the immediately preceding, plus one sixth of the days spent in the U.S. in the second preceding year amount to at least 183 days.

7 A married couple can gift an amount up to $28,000.

should involve foreign situs assets that would otherwise be subject to the succession tax.

- Because the generation skipping transfer tax ("G.S.T.T.") does not apply to covered gifts, a covered expatriate should consider transferring assets for the benefit of individuals more than one generation removed from himself. Such transfers would still be subject to the succession tax but not to the G.S.T.T.

- If a covered expatriate inherits property from a foreign person who is not a covered expatriate, and in time will transfer that property to a U.S. person as a covered gift or bequest, the property will be subject to the succession tax. Thus, the individual should plan for the property to bypass the covered expatriate entirely to avoid the application of the succession tax. This may entail the making of complete and timely disclaimers in trust interests, bequests, and gifts that are effective under local law.

CONCLUSION

At first glance, expatriation may result in the imposition of significant tax liability for a covered expatriate and U.S. heirs. However, in the period since the expatriation tax was enacted, planning techniques have arisen to redress the tax situation for many "near wealthy" individuals and couples with $10.00 million to $15.00 million net worth. Whether the plan involves retaining a foreign domicile for a Green Card holder or choosing to pay gift tax rather than succession tax, opportunities exist for reducing the sting of departing the U.S.