The Tax Consequences of Expatriation

PATRICK J. McCORMICK

Overall expatriation numbers have increased exponentially in the past decade. This article details the potential tax effects.

The U.S. is one of the few countries in which citizens are taxable based on their worldwide income, regardless of their country of residence. Only a few other countries–the Philippines is one–take this approach to individual taxation, with the majority of countries taxing only residents on worldwide income. The same ramifications–tax on worldwide income, regardless of actual residency–will also typically apply to U.S. green card holders,[1] even during periods when they are not living in the U.S.

These tax ramifications, combined with a multitude of other factors, both financial and otherwise, have led to a marked increase in citizenship renunciation and green card forfeiture by long-term green card holders (collectively, "expatriation"). In 2016, 5,411 individuals expatriated from the U.S., up from 4,279 in 2015; overall numbers have increased exponentially in the past decade.

As may be expected, there are tax consequences on expatriation. Based on the expatriate's specific facts, an "exit tax" may be imposed on his or her U.S. departure. This article looks at expatriation generally, details the potential tax effects, and discusses techniques to minimize the financial impact of expatriation, including gifting strategies prior to expatriation.

EXPATRIATION PROCEDURES

The Code defines an expatriate to include: (1) a U.S. citizen who relinquishes citizenship, and (2) any long-term U.S. resident who ceases to be a lawful permanent resident.[2] A long-term resident is a noncitizen individual who is a lawful U.S. permanent resident (i.e., a green card holder) in at least eight tax years during the 15 tax years ending with the tax year in which the expatriating event occurs.[3] Importantly, this means that not all green card holders will be classified as expatriates–only those who meet the aforementioned "eight out of 15" test.

An individual expatriates as of the date of relinquishment of citizenship (for citizens) or the date that he or she ceases being a lawful permanent resident (for green card holders).[4] Formal procedures can be undertaken to expatriate. For example, citizens can relinquish citizenship by renouncing before a diplomatic or consular officer of the U.S. (followed by the issuance of a loss of nationality certificate) or providing a statement to the State Department. Long-term residents can file U.S. Citizenship and Immigration Services (USCIS) Form I-407, Record of Abandonment of Lawful Permanent Resident Status, to abandon permanent resident status.

There are also involuntary methods of expatriation. As a nontax matter, individuals considering expatriation will want to ensure that, after expatriation, they will have full rights as a national of another country (to avoid being rendered stateless through their withdrawal from the U.S.).

Expatriates (whether or not covered expatriates, as defined below) file dual-status income tax returns for the year in which they expatriate. Dual-status taxpayers who are not U.S. residents on the last day of the tax year file Form 1040NR, U.S. Nonresident Alien Income Tax Return. Filers write "Dual-Status Return" across the top of Form 1040NR and include a statement to cover the portion of the year in which they were subject to tax (Form 1040, U.S. Individual Income Tax Return, can be used as this statement).[5] In addition, for reporting purposes related to the expatriation event itself, Form 8854, Initial and Annual Expatriation Statement, is filed with the expatriate's tax return in his final year of residency/citizenship.

Current-year expatriates are generally required to complete Parts I, IV, and V of Form 8854, disclosing (among other items) prior-year income tax liability, net worth, and a balance sheet (all of which become relevant for purposes of the exit tax, as discussed below). Individuals who fail to file Form 8854 when required to do so may be assessed a $10,000 penalty.[6]

The tax consequences of expatriation are discussed below.

COVERED EXPATRIATES

As stated above, the primary tax ramification for expatriation is the potential applicability of the exit tax, which is assessable to "covered expatriates." A "covered expatriate" is an expatriate who meets any of the following tests (subject to exceptions noted below): (1) the individual's average net income tax for the period of five tax years ending before the cessation date is greater than $162,000 for 2017 ("tax liability test"); (2) the individual's net worth as of the cessation date is $2 million or more ("net worth test"); or (3) the individual fails to certify under penalty of perjury that he of she has met the requirements of the U.S. Tax Code for the five preceding tax years or fails to submit whatever evidence of compliance the IRS requires ("certification test").[7]

Tax Liability Test

An expatriate meets the tax liability test (and thereby becomes a covered expatriate) when his or her average net income tax (the tax owed on income, not the income amount itself) for the past five tax years pre-expatriation exceeds $162,000 (adjusted annually for inflation).[8] An individual's net income tax liability is determined under Section 38(c)(1). Individuals filing joint income tax returns must consider the net income tax reflected on the joint return.[9] Certain credits are available for purposes of determining the net income tax liability–foreign tax credits are one of the credits taken into account.[10]

Net Worth Test

Most often, individuals will be classified as "covered expatriates" based on the net worth test, which is met when the expatriating individual's net worth (at the time of expatriation) exceeds $2 million.[11] Under the net worth test, an individual is considered to own any interest in property that generally would be taxable as a gift if the individual were a citizen or resident of the U.S. who transferred the interest immediately prior to expatriation.[12] An interest in property includes money or other property, regardless of whether it produces any income or gain. Also, an interest in the right to use property is treated as an interest in the property itself.[13]

For valuation purposes, asset values are generally determined under gift tax principles (without inclusion of discounts). A taxpayer must use good faith estimates as to asset values; however, formal appraisals are unrequired. Liabilities (such as mortgages) are deducted for purposes of the net worth test. An individual's interest in a trust is also included for net worth purposes. A two-step process is undertaken to determine the value of the trust attributable to the expatriate–first, interests in trusts are allocated proportionately among all beneficiaries by considering all facts and circumstances; interests allocable to the expatriate are then valued.[14]

Certification Test

Expatriates are classified as covered expatriates when they cannot certify compliance with IRS requirements for the five years prior to expatriation.[15] Importantly, this requirement can cause an individual without significant net income or net worth to be subject to the exit tax. Expatriates must certify that, for the five years prior to expatriation, all tax requirements have been met. The certification required is made by filing Form 8854.

PATRICK J. McCORMICK, LL.M., is an associate with Kulzer & DiPadova, P.A. in Haddonfield, New Jersey. He specializes in the areas of international taxation, tax compliance, and offshore reporting obligations. Mr. McCormick has written previously for the Journal.

Exceptions

An individual meeting either the tax liability test or net asset test can avoid classification as a "covered expatriate" by meeting one of two statutory exceptions. These exceptions apply to an individual who: (1) became at birth a dual citizen of the U.S. and another country, remains a citizen of that other country as of his or her expatriation date, and did not reside in the U.S. for more than ten of the past 15 tax years (ending with the tax year during which expatriation occurs); or (2) relinquishes U.S. citizenship before age 18½ and did not reside in the U.S. for more than ten tax years before the date of relinquishment.[16] Both of these (narrow) exceptions apply only to citizens (though green card holders can be excluded from expatriate status entirely if they do not meet the "eight out of 15" requirement mentioned previously).

EXIT TAX IMPLEMENTATION – "MARK-TO-MARKET" REGIME

Individuals classified as covered expatriates are subject to an exit tax on expatriation. Functionally, the expatriate is treated as selling at fair market value his or her worldwide holdings (subject to a few exceptions) as of the day before expatriation, creating a fictional recognition event for all built-in gain of worldwide assets—these are termed the "mark-to-market" rules. Gain is reported on the individual's Form 1040 (since recognition occurs the day before expatriation, i.e., while they are still subject to worldwide taxation by the U.S.).

Mark-to-Market Mechanics

Generally, the expatriate is treated as owning any property that would be treated as part of his or her estate, and is also considered to be the owner of his or her beneficial interests in trusts (with the value of such interests determined in the same way as under the net asset test). Fair market value of assets held is also determined under general estate tax guidelines.[17]

An individual's basis generally follows general principles for determination of basis, with one important deviation—the basis of long-term residents in their assets is the fair market value of those assets on the date that their residence in the U.S. began.[18] This can be an important benefit for assets that appreciated in value prior to the expatriate becoming a U.S. resident. For residents who do not want this provision to apply (i.e., those whose asset values, on an aggregated basis, declined between date of acquisition and date of U.S. residency), an election out of this treatment can be made; importantly, this election is made property by property. The Service has said that it intends to use regulatory authority to exclude from the election U.S. real property and property used or held for use in connection with the conduct of a trade or business within the U.S.[19]

Once the fair market value and basis of each asset has been ascertained, gain (and loss) is aggregated to determine the amount of gain recognition under the mark-to-market regime. Some relief is available—the first $699,000[20] (for 2017) of gain under mark-to-market rules is not subject to tax.[21] The exclusion must be allocated pro rata among all built-in gain property (the expatriate cannot choose assets to which he or she will apply the exclusion amount). After this allocation, gains (and losses) are reported on the Form 1040 (and applicable schedules) depending upon the character of each asset. The basis of each asset subject to the mark-to-market regime is stepped up after the rules are applied, *even where gain is not recognized based on the exclusion amount*.[22]

Deferral for payment of the exit tax is available by election, and is made asset by asset.[23] When this election is made, payment of the tax is not required until each asset for which an election was made is sold.[24] However, security must be posted for each asset; interest must be paid on amounts owed (calculated at the underpayment rate under Section 6621 from the due date of the return for the tax year that includes the day prior to expatriation); and treaty benefits must be waived.[25] Also, the expatriate must enter into a tax deferral agreement with the Service. A template for the agreement is available (the agreement must appoint a U.S. agent for the expatriate).[26]

Exceptions for Specific Assets

The mark-to-market regime does not apply to three types of assets: (1) deferred compensation items, (2) specified tax-deferred accounts, and (3) interests in nongrantor trusts.[27] For eligible deferred compensation items, the payor must withhold a tax of 30% on any taxable payment to a covered expatriate; for ineligible deferred compensation items, an expatriate is subject to tax as if it were received the day prior to expatriation.[28] Generally, eligible deferred compensation items are those for which the payor is a U.S. person (or the payor elects to be treated as a U.S. person) and the expatriate notifies the payor of his or

NOTES

1 See Strohl, "Green Card Checklist," 28 JOIT 56 (February 2017).
2 Section 877A(g)(2).
3 Section 877A(g)(3)(B).
4 Section 877A(g)(2).
5 See IRS Pub. 519, "U.S. Tax Guide for Aliens," p. 34 ("Filing Information").
6 Section 6039G(c).
7 Section 877(a)(2).
8 Section 877(a)(2)(A); see also Rev. Proc. 2016-55, 2016-45 IRB 707.
9 See Notice 97-19, 1997-1 CB 394.
10 See Section 27.
11 Section 877(a)(2)(B).
12 Notice 97-19, *supra* note 9; see also Notice 2009-85, 2009-45 IRB 598.
13 *Id.*
14 *Id.*
15 Section 877(a)(2)(C).
16 Section 877A(g)(1)(B).
17 Notice 2009-85, *supra* note 12.
18 Section 877A(h)(2).
19 Notice 2009-85, *supra* note 12.
20 This number is adjusted annually for inflation. See Rev. Proc. 2016-55, 2016-45 IRB 707.
21 Section 877A(a)(3).
22 Notice 2009-85, *supra* note 12.
23 *Id.*
24 Section 877A(b)(1).
25 Section 877A(b)(2); Notice 2009-85, *supra* note 12.
26 See Notice 2009-85, *supra* note 12.
27 Section 877A(d)-(f).
28 Section 877A(d).

her status (and irrevocably waives any right to claim treaty benefits regarding withholding).[29]

Tax-deferred accounts are treated as having their entire balance distributed to the expatriate on the day before his or her expatriation date.[30] For distributions of property from a nongrantor trust to a covered expatriate, the trustee withholds 30% of the taxable portion of the subsequent distribution.[31]

POST-EXPATRIATION RAMIFICATIONS

Given the above, most would assume that once expatriation is completed, the U.S. tax ramifications cease finally and mercifully. However, this belief (at least in some instances) would be mistaken. Specifically, special rules apply to gifts or bequests from covered expatriates to U.S. citizens or residents. These gifts or bequests are subject to tax at the highest applicable tax rate for estate and gift purposes (currently 40%).[32] Tax owed is to be paid by the recipient of the gift or bequest.[33] Satisfaction of these requirements is deferred until the Service issues guidance on the same. Proposed Regulations regarding gifts and bequests from covered expatriates were issued in 2015.[34] Form 708, U.S. Return of Gifts or Bequests From Covered Expatriates, is to be used to report such gifts or bequests, but has yet to be issued. [35]

Planning for Expatriation

As illustrated by the above, individuals subject to the exit tax can face drastic tax ramifications on expatriation; however, steps can be taken prior to expatriation to mitigate (or eliminate) the effects of the tax. The most significant is use of lifetime exclusion amounts prior to expatriation. For U.S. citizens and residents, a $5.49 million (for 2017) lifetime exclusion is available for gratuitous transfers.[36] Mark-to-market rules (and the exit tax rules generally) do not provide this exclusion to shield gain on expatriation; thus, exhaustion of this amount prior to expatriation is beneficial from an exit tax perspective–so long as the expatriate is comfortable with lifetime gifting and will have sufficient assets after gifting for their planned and potential needs moving forward. Transfers to trusts can also be used but care must be undertaken to ensure both that the expatriate does not retain an interest sufficient to cause inclusion for the net worth test, and that trust usage does not cause adverse consequences in the expatriate's subsequent country of residence.

Conclusion

Expatriation can be motivated by both financial and other factors. In either case, contemplation of tax repercussions is required. Individuals who are exploring cutting ties with the U.S. should consult with tax advisors as an initial step to ensure that the tax consequences of their decision are minimized. ●

NOTES

29 *Id.*

30 Section 877A(e).

31 Section 877A(f).

32 Section 2801(a).

33 Section 2801(b).

34 REG-112997-10, 9/9/15, 2015-39 IRB 422.

35 See Notice 2009-85, *supra* note 12

36 Section 2505(a).