

Significant Changes to U.S. Taxation of Expatriating Citizens and Long-Term Residents

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On June 17, 2008, President Bush signed into law the Heroes Earnings Assistance and Relief Tax Act of 2008 (P.L. 110-245, the “Act”). As part of the revenue offsets for the Act’s benefits for military service members, the Act significantly alters the U.S. federal tax treatment of expatriating U.S. citizens and long-term permanent residents (*i.e.*, green card holders). The Act adds Internal Revenue Code sections 877A and 2801. These provisions of the Act are effective for expatriations on or after June 17, 2008, and gifts and bequests made on or after June 17, 2008. Prior law continues to apply to individuals and transfers not subject to the new rules. The following are the Act’s principal expatriation changes.

- *“Mark-to-Market” Regime.* Tax is imposed, subject to a possible deferral election, on the net unrealized gain of property upon expatriation, as if the property had been sold for fair market value.
- *Deferred Compensation and Tax Deferred Accounts.* A 30 percent withholding tax is imposed on payments of eligible deferred compensation; the present value of non-eligible deferred compensation and specified tax deferred accounts is deemed distributed and taxable immediately prior to expatriation.
- *Grantor Trusts.* The “mark-to-market” regime applies to property held in grantor trusts.
- *Nongrantor Trusts.* A 30 percent withholding tax is imposed on distributions to expatriates and nongrantor trusts recognize gain on distributions of appreciated property to expatriates.
- *Estate and Gift Tax.* A transfer tax is imposed on U.S. citizens or residents acquiring property by bequest or gift from an expatriate.

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Background

U.S. Federal Income Taxes

U.S. citizens and resident aliens are generally subject to U.S. federal income tax on their worldwide income. Nonresident aliens are taxed at a flat rate on “fixed or determinable annual or periodic income” (*e.g.*, most passive investment income) derived from U.S. sources and at graduated rates on income “effectively connected” with the conduct of a U.S. trade or business. Prior to the American Jobs Creation Act of 2004 (P.L. 108-357), former U.S. citizens were subject to an expatriation tax on U.S.-source income (more broadly defined than for nonresident aliens generally) at rates applicable to U.S. citizens for the following ten taxable years, unless the loss of U.S. citizenship did not have as one of its principal purposes the avoidance of U.S. federal income, estate or gift taxes. The Health Insurance Portability and Accountability Act of 1996 (P.L. 104-191) caused certain high income tax paying or high net worth individuals to be treated as automatically having the proscribed tax avoidance purpose and extended the expatriation rules to long-term U.S. residents. The American Jobs Creation Act of 2004 eliminated the tax avoidance purpose test and made the expatriation tax rules applicable only to certain high income tax paying or net worth individuals and to individuals failing to certify compliance with U.S. federal income tax laws for the five taxable years preceding the taxable year of expatriation.

U.S. Federal Estate and Gift Taxes

Estates of U.S. citizens and residents are subject to U.S. federal estate tax on worldwide property. The definitions of “resident alien” and “nonresident alien” contained in Internal Revenue Code section 7701(b), including the “substantial presence” test, explicitly do **not** apply for U.S. estate and gift tax purposes. Estates of nonresidents are subject to U.S. federal estate tax on transfers of U.S.-situs property, including real estate and tangible property located in the United States, stock in U.S. corporations and non-portfolio debt obligations of U.S. persons. Additionally, U.S. citizens and residents are subject to U.S. federal gift tax on all gifts of worldwide property. Generally, nonresidents are only subject to U.S. federal gift tax on gifts of U.S.-situs property, which does not include intangibles such as stock or debt obligations,

regardless of where the intangibles are located. Prior to the Act, the estates of former U.S. citizens and long-term residents subject to the expatriation federal income tax regime of Internal Revenue Code section 877 on the individual's date of death were subject to U.S. federal estate tax on U.S.-situs property, expanded to include the stock of certain foreign corporations (to the extent of their U.S.-situs assets). Similarly, prior to the Act individuals subject to the expatriation income tax regime on the date of any gift were subject to U.S. federal gift tax on gifts of U.S.-situs property, expanded to include the stock of the same foreign corporations and to the same extent as the estate tax rules, stock of U.S. corporations and all debt obligations of U.S. persons.

The Act

Covered Expatriates

The Act continues prior law by applying the expatriation regime to former U.S. citizens and former long-term residents who (i) have an average net income tax liability for the five taxable years ending before the expatriation date that exceeds \$139,000 as of 2008, adjusted for inflation, (ii) have a net worth of \$2 million or more on the expatriation date or (iii) fail to certify under penalties of perjury that they have complied with all U.S. federal tax obligations for such five preceding taxable years or fail to submit evidence of such compliance when required. *I.R.C. § 877A(g)(1)(A)*. And the Act retains the definition of long-term resident as any individual who has been a lawful permanent resident (*i.e.*, green card holder) in at least eight out of the last 15 taxable years ending with the year in which the individual ceases to be a lawful permanent resident or commences to be treated as a resident of a foreign country under a tax treaty and does not waive the benefits of that treaty. *I.R.C. § 877A(g)(2)*. An individual does not need to be a green card holder for a full eight years; holding a green card for any one day during a taxable year is sufficient for that year to count towards the eight-year threshold. On the other hand, if an individual is a resident in the United States during a taxable year, but not a green card holder, that year will not count towards meeting the eight-year threshold for long-term residency.

However, the Act modifies the prior law exceptions for certain dual citizens and individuals relinquishing U.S. citizenship before age 18½. An individual born with citizenship in both the United States and another country who relinquishes U.S. citizenship is not subject to the expatriation regime if as of the expatriation date the individual continues to be a citizen of and taxable

as a resident of such other country and has not been a resident of the U.S. for more than ten of the 15 taxable years ending with the taxable year of expatriation. *I.R.C. § 877A(g)(1)(B)(i)*. A U.S. citizen relinquishing his or her U.S. citizenship before age 18½ is not subject to the expatriation regime if the individual was a resident of the U.S. (determined under the "substantial presence" test of Internal Revenue Code section 7701(b)(1)(A)(i)) for no more than ten taxable years before such relinquishment. *I.R.C. § 877A(g)(1)(B)(ii)*. These exceptions do not apply to individuals who become subject to the expatriation regime because of a failure to certify compliance with U.S. federal tax obligations.

Timing of Expatriation

The Act changes prior law that provided that an individual continues to be treated as a U.S. citizen or long-term resident for U.S. federal income tax purposes until the individual gives notice of an expatriating act or termination of residency. Under the Act, an individual ceases to be a U.S. citizen for U.S. tax purposes upon relinquishment of his or her U.S. citizenship, deemed to occur on the earliest of (i) the date the individual renounces U.S. nationality before a diplomatic or consular officer of the United States (provided that the voluntary relinquishment is later confirmed by the issuance of a certificate of loss of nationality), (ii) the date that the individual furnishes to the State Department a signed statement of voluntary relinquishment of U.S. nationality confirming the performance of an expatriating act (again, provided that the voluntary relinquishment is later confirmed by the issuance of a certificate of loss of nationality), (iii) the date that the State Department issues a certificate of loss of nationality and (iv) the date that a U.S. court cancels a naturalized citizen's certificate of naturalization. *I.R.C. §§ 877A(g)(3), (4)*. Long-term residency continues to terminate when an individual loses his or her green card status through revocation or has been administratively or judicially determined to have abandoned such status, but now also terminates if an individual is treated as a resident of a foreign country having a tax treaty with the United States, does not waive the benefits of that treaty and notifies the Internal Revenue Service of such treatment. *I.R.C. § 7701(b)(6), as amended by the Act*.

U.S. Federal Income Tax Provisions

"Mark-to-Market" Regime

Under the Act, covered expatriates will be subject to U.S. federal income tax on the net unrealized gain on their world wide property as if that property had

been sold for fair market value on the day before expatriation. *I.R.C. § 877A(a)(1)*. This tax applies only to the extent that the net gain exceeds \$600,000, adjusted for inflation. *I.R.C. § 877A(a)(3)*. For purposes of the “mark-to-market” tax, property held by an individual on the date such individual became a resident of the United States is considered to have a basis on that date of no less than the property’s then fair market value unless an irrevocable election is made for the basis to be calculated under general U.S. tax principals. *I.R.C. § 877A(h)(2)*. Gain is taken into account without regard to any other Code provisions; loss may be taken into account only as provided in the Code, except that the “wash sale” rules of Internal Revenue Code section 1091 do not apply. *I.R.C. § 877A(a)(2)*. Gains or losses subsequently realized are adjusted to take into account gain subject to the “mark-to-market” tax, determined without regard to the \$600,000 exemption amount. *I.R.C. § 877A(a)*.

Individuals may elect to defer payment of all or a portion of the “mark-to-market” tax until property is sold. *I.R.C. § 877A(b)(1)*. This election is made with respect only to property identified by the taxpayer in the election and is irrevocable. *I.R.C. § 877A(b)(6)*. The amount of “mark-to-market” tax attributable to property is the same proportion of the total tax as the ratio of the property’s gain subject to the tax bears to the total gain so subject. *I.R.C. § 877A(b)(2)*. Interest accrues during the deferral period at the normal underpayment rate. *I.R.C. § 877A(b)(7)*. Any deferred tax is generally due at the earlier of the due date of the return for the taxable year during which the property is disposed of or for the taxable year that includes the individual’s death. *I.R.C. § 877A(b)(3)*.

In order to be eligible to make the election, an individual must furnish a bond or letter of credit to the Internal Revenue Service and must waive treaty rights that would preclude the assessment or collection of taxes. *I.R.C. §§ 877A(b)(4), (5)*.

Deferred Compensation and Specified Tax Deferred Accounts

Under the Act, withholding requirements apply to deferred compensation of expatriates arising from both services performed in the United States and services performed while an individual was a citizen or resident of the United States. *I.R.C. § 877A(d)(5)*. Deferred compensation will be considered “eligible” if the payor is a U.S. person or non-U.S. person that elects to be treated as a U.S. person for purposes of withholding, and if the

expatriate notifies the payor of his expatriate status and irrevocably waives a claim of withholding reduction under a tax treaty. *I.R.C. § 877A(d)(3)*.

If the deferred compensation is eligible deferred compensation, the payor must deduct and withhold 30 percent of the payment if that payment would be included in gross income had the expatriate been a U.S. citizen or resident. *I.R.C. § 877A(d)(1)(A)*. The timing of the withholding is the same as if the expatriate were a U.S. citizen or resident, and the income is also subject to tax under Internal Revenue Code section 871. *I.R.C. §§ 877A(d)(1)(B), 877A(d)(6)(B)*.

On the other hand, if deferred compensation is not eligible deferred compensation, the present value of the deferred compensation is treated as being received on the day before the expatriation date. *I.R.C. § 877A(d)(2)(A)(i)*. Additionally, expatriation causes property transferred in connection with the performance of services to be treated as transferable and as ceasing to be subject to a risk of forfeiture on the day preceding the expiration date for purposes of Internal Revenue Code section 83. *I.R.C. §§ 877A(d)(2)(A)(ii), 877A(d)(4)(D)*.

If an expatriate holds an interest in specified tax deferred accounts (such as health savings accounts and certain IRAs) on the day before expatriation, the expatriate is treated as receiving a distribution of his entire interest on the day before expatriation, and that deemed distribution is taxed accordingly. *I.R.C. § 877A(e)*.

With respect to both deferred compensation and specified tax deferred accounts, appropriate adjustments are made for subsequent distributions to take into account the earlier taxation. *I.R.C. § 877A(d)(2)(C)*. Additionally, early distribution taxes do not apply to the deemed distributions. *I.R.C. § 877A(d)(2)(B)*.

Grantor Trusts

In general, a person treated as the owner of property held in a grantor trust includes in that person’s own federal income tax return items of income and deduction of that property. *I.R.C. §§ 671, et seq.* Accordingly, the Act’s “mark-to-market” tax applies to that portion of a grantor trust of which a covered expatriate is deemed to be the owner immediately before the expatriation date. And, if a grantor trust becomes a nongrantor trust after expatriation, that trust remains a grantor trust for purposes of taxation under the Act. *I.R.C. § 877A(f)(3)*.

Nongrantor Trusts

Under existing law, a transfer of property by a U.S. person to a foreign estate or trust is treated by the transferor as if the property had been sold to the estate or trust. *I.R.C. § 684*. This rule also applied if a domestic trust becomes a foreign trust.

Under the Act, where a covered expatriate is the beneficiary of a nongrantor trust on the day before expatriation, upon any subsequent distribution from the trust, the trustee must deduct and withhold 30 percent of the amount that would be includible in the gross income of an expatriate as if he or she was still a U.S. citizen. *I.R.C. § 877A(f)*. This distribution is subject to tax under Internal Revenue Code section 871, and the expatriate is treated as having waived any right to claim any reduction in withholding under a tax treaty. *I.R.C. § 877A(f)(4)(B)*. The Act's legislative history clarifies that a distribution includes an expatriate becoming the owner of trust property under the grantor trust rules. Additionally, if the trust distributes appreciated property to an expatriate, the trust must recognize gain as if the property were sold at its fair market value. *I.R.C. § 877A(f)(1)(B)*.

Additional Rules

Under the Act, when holding property for a minimum amount of time results in a reduction of recognized gain, such as with like-kind exchanges or involuntary conversions, the property will be deemed disposed of on the date an individual expatriates. *I.R.C. § 877A(h)(1)(A)*. Additionally, extensions of time for payment of taxes cease on the day an individual expatriates, and unpaid taxes become due upon expatriation. *I.R.C. § 877A(h)(1)(B)*. The Act's legislative history indicates that the information return requirements currently applicable to former U.S. citizens and long-term residents under Internal Revenue Code section 6039G continue to apply.

U.S. Federal Estate and Gift Tax Provisions

Under the Act, a transfer tax is imposed on a U.S. citizen or resident on any property acquired from a covered expatriate by bequest or gift. *I.R.C. § 2801(b)*.

The transfer tax is assessed at the highest marginal estate or gift tax rate applicable at the time of the bequest or gift. *I.R.C. § 2801(a)(1)*. However, the tax so imposed is reduced by the amount of any foreign estate or gift tax paid on the bequest or gift. *I.R.C. § 2801(d)*. Additionally, the gift tax annual exclusion applies, as do the rules for charitable donations and spousal transfers under the general estate and gift tax rules, and only those assets not included on a U.S. federal estate or gift tax return will be assessed the transfer tax. *I.R.C. §§ 2801(c), (e)*.

If a gift or bequest is made to a domestic trust, the tax applies as if the trust were a U.S. citizen and the trust is required to pay the tax. *I.R.C. § 2801(e)(4)(A)*. If a gift or bequest is made to a foreign trust, the tax applies to any distribution from the trust to a U.S. citizen or resident beneficiary; for income tax purposes, the beneficiary may deduct the amount of this tax to the extent that it was imposed on an amount also included in his or her gross income. *I.R.C. § 2801(e)(4)(B)*. A foreign trust may make an election to be treated as a domestic trust solely for purposes of these rules, but this election is generally irrevocable. *I.R.C. § 2801(e)(4)(B)(iii)*.

Material Available On-Line

The following material is available with the indicated file sizes:

- **Heroes Earnings Assistance and Relief Tax Act of 2008, P.L. 110-245, § 301** [64K]
- **Technical Explanation by the Joint Committee on Taxation, pp. 36-46** [56K]

Important Information for Readers

This material is not intended to constitute a complete analysis of all tax considerations. Internal Revenue Service regulations generally provide that, for the purpose of avoiding United States federal tax penalties, a taxpayer may rely only on formal written opinions meeting specific regulatory requirements. This material does not meet those requirements. Accordingly, this material was not intended or written to be used, and a taxpayer cannot use it, for the purpose of avoiding United States federal or other tax penalties or of promoting, marketing or recommending to another party any tax-related matters.