

The U.S. Departure Tax

By Solomon Packer

Solomon Packer describes the recently enacted U.S. departure tax, which taxes built-in gains in excess of \$600,000 from assets owned by “covered” expatriating U.S. citizens and long-term residents who relinquish their green card.

The news is, after 22 years of first floating the “departure tax” concept, and after several attempts at amending the legislation, the United States has now enacted a “departure tax.” This new tax is included as Sec. 877A of the Internal Revenue Code (“the Code”) and was enacted as Act. Sec. 301(a) of the Heroes Earnings Assistance and Relief Tax Act of 2008.¹ These new rules apply to expatriations occurring on or after June 17, 2008.

Congress for several years has been deliberating on whether to tax built-in gain of assets owned by expatriating U.S. citizens and long-term residents (LTRs) who relinquish their green card. This question as to taxability has now been answered in the affirmative. A tax is now imposed where the “covered” citizen or LTR has built-in gain in excess of \$600,000 on the date the person expatriates or relinquishes his or her green card.

Consistent with the most recent legislative changes to Code Sec. 877, there is no need for the expatriation to be tax motivated for Code Sec. 877A to apply. Code Sec. 877A, as in prior law, includes several categories of U.S. citizens who might be excluded from application of the statute. LTRs are not covered expatriates unless they held their green card for 10 out of the 15 years ending on the date of expatriation.² Formerly, LTRs were subject to the expatriation tax if they had a green card for eight years out of the last 15 years.

Consistent with prior law, Code Sec. 877A applies to expatriating citizens or LTRs whose:

1. average annual income tax on net taxable income, for the five year period ending before the date of expatriation, is greater than \$124,000 (\$139,000 for 2008);
2. the net worth of the individual on the date of expatriation is \$2,000,000; or
3. the individual fails to certify under penalties of perjury that he or she has met his or her Federal tax obligations for the five preceding years or fails to submit such evidence of such compliance as the Secretary might require.

Form 8854, *Initial and Annual Expatriation Information Statement*, provides the means to make the tax and asset calculations. The Form includes the required certification under penalties of perjury. Both the tax and built-in gain thresholds are to be inflation adjusted. The date of a citizen’s relinquishment of nationality is the date of renunciation before a U.S. Consular Officer. A voluntary renunciation, however, is not effective until the citizen receives an approved certificate of loss of nationality from the Department of State. The expatriation date for a LTR is the date the expatriate ceases to be a lawful permanent resident of the United States.

The expatriation provisions now operate as a departure tax. The legislation eliminates the 10 year alternative tax rule, which sought to tax the LTR or expatriating citizen’s U.S.-source income over the succeeding 10 year period. Under Code Sec. 877A, when the expatriate’s built-in gain on assets

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exceeds \$600,000, the expatriate is required to pay the tax on such gain. This is effectively a new mark-to-market regime. The covered expatriate, however, can elect, on an asset-by-asset basis, to defer the tax payment until the due date for the year the property is actually sold, or the final return for the year of the expatriate's death.

A taxpayer seeking to make this irrevocable election can be required to post security. The taxpayer would be required to waive rights under any U.S. tax treaty that otherwise might preclude the collection of this tax. The cost of this election is an interest charge, based on the rates applicable to underpayments of tax.

When applying the mark-to-market tax to a covered LTR, the adjusted basis of property deemed sold by the LTR is the fair market value of property when the LTR first became a tax resident of the United States. A covered LTR can irrevocably elect not

to apply this rule. It is not clear whether this election can be made on a property-by-property basis.

Under prior law, if during the 10 year period following expatriation an expatriate returns to the United States in any year for more than 30 days, the expatriate was subject to U.S. tax as a citizen or resident for that tax year. The new legislation does not include a 30 day rule. Rather, if a covered expatriate becomes a U.S. citizen or tax resident, the special 30-percent tax withholdings on deferred compensation and non-grantor trust distributions would no longer apply. Also the special transfer tax under Code Sec. 2801 would no longer apply.

Deferred Compensation Items

Tax on eligible deferred compensation items is deferred until payments are actually made. Eligible deferred compensation payments are payments under a domestic or foreign employer pension plan, a deferred compensation plan or any rights to receive property for services previously rendered that were not previously taxed under Code Sec. 83. When an eligible tax deferred item is paid to a covered expatriate, the payor is required to withhold tax of 30 percent. This payment is in lieu of any withholding

requirement under present law. For tax on an eligible deferred compensation plan to qualify for deferral:

1. the payor needs to be a U.S. person or a foreign person who elects to be treated as a U.S. person for purposes of withholding, and
2. the covered expatriate advises the payor of his U.S. tax status and the required withholding tax, and irrevocably waives any claim to benefits of reduced withholding tax under an income tax treaty.

The present value of deferred compensation items not eligible for tax deferral are treated as earned and

received on the date prior to expatriation and are included in the covered expatriate's taxable income. Such income is not again taxed when actually received. These deemed distributions are not subject to early distribution taxes. The deferred compensation rules would not apply to deferred compensation items attributable to

services performed outside the United States while the covered expatriate was not a citizen or resident of the United States.

Specified Tax Deferred Accounts

The term "specified tax deferred accounts" include a covered expatriate's Code Sec. 529 Plan, Health Savings Account and Archer Medical Savings Account. A covered expatriate is treated as receiving a distribution of his entire interest in these accounts on the day prior to his expatriation. These deemed distributions are not subject to an early distribution tax.

Trusts

Assets of a grantor trust for which the covered expatriate is considered the grantor are subject to the mark-to-market tax discussed above. The rules are more complicated if the covered expatriate is a beneficiary of a non-grantor trust. With respect of any direct or indirect distribution to the covered beneficiary from such trust, the trustee must withhold from the distribution 30 percent of the amount that would be includible in the covered expatriate's gross

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income if the expatriate were subject to U.S. tax as a citizen or resident of the United States.

The covered expatriate is treated as having waived any right to claim a reduced treaty withholding tax rate. If appreciated property is distributed to the covered expatriate, the trust must recognize gain as if the property were sold to the covered expatriate at the property's fair market value. Neither the statute nor the Joint Committee Explanation discuss how the United States acquires jurisdiction to require foreign trustees of a foreign trust to withhold U.S. tax of 30 percent on distributions to a covered expatriate. If, as a result of an expatriation, a domestic trust becomes a foreign trust, the general tax rules of Code Sec. 684 apply prior to application of Code Sec. 877A. That is, the trust's assets are deemed to have been sold by the domestic trust at fair market value.

Special Transfer Tax

Under prior rules, the taint of expatriation terminated after 10 years. Under the new rules, the expatriation taint has an indeterminate life. Gifts or bequests made by a covered expatriate and received by a U.S. citizen or resident are, now, taxable to the recipient.³ The tax is calculated by applying the highest marginal estate tax rate or gift tax rate, whichever yields a higher tax, to the amount of the gift or bequest. The tax is imposed on gifts or bequests exceeding the amount specified in Code Sec. 2503(b), \$12,000 for 2008. Again, this tax is imposed on the recipient of the

covered gift or bequest and is imposed on a calendar year basis. A credit against this tax is permitted for any gift or estate tax paid to a foreign country with respect of the covered gift or bequest.

Where a covered gift or bequest is received by a U.S. trust, the trust is responsible for the payment of this tax. Where the covered gift or bequest is received by a foreign trust, the tax applies to any distribution of income or corpus attributable to the covered gift or bequest received by a U.S. citizen or resident, in the same manner as if the distribution were a covered gift or bequest. A tax deduction is permitted with respect of this tax to the extent such tax is imposed on the portion of the distribution included in the gross income of the U.S. citizen or resident.

This special transfer tax is not payable with respect to property that is otherwise subject to U.S. estate or gift tax, and such property is included on a timely filed return of the covered expatriate or his estate. Also, gifts or bequests made by a covered expatriate to a spouse or charity are not subject to the special transfer tax if they would not be subject to U.S. tax if made by a U.S. decedent or donor. It is believed that these special transfer taxes applicable to gifts or bequests made by covered expatriates to U.S. beneficiaries will be a significant deterrent to expatriation.

ENDNOTES

¹ Act Sec. 301(a) of the Heroes Earnings Assistance and Relief Tax Act of 2008 (P.L. 110-245).

² Code Sec. 877A(g)(B)(i)(II).

³ Code Sec. 2801.

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