Steve Leimberg's Estate Planning Email Newsletter - Archive Message #1324

Date:	23-Jul-08
From:	Steve Leimberg's Estate Planning Newsletter
Subject:	**HEART Legislation Enacts New Expatriation Rules**

"US *recipients* of gifts and bequests from Covered Expatriates will now incur gift and estate tax"

Kevin Packman tells **LISI** members that "not only must you pay to leave, but now there's proof that there is no such thing as a free gift".

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EXECUTIVE SUMMARY:

The financial consequences of expatriating were significantly changed on June 17, 2008 when President Bush signed the Heroes Earnings Assistance and Relief Tax Act of 2008 (the "HEART Legislation"). Not only is their now a direct financial cost to select individuals who expatriate ("Covered Expatriates) as they will incur an exit tax (IRC 877A), but the US *recipients* of gifts and bequests from such Covered Expatriates will now incur gift and estate tax (IRC 2801). The Heart Legislation became effective as of June 17, 2008 and introduced new IRC Section 877A and 2801.

FACTS:

WHO DOES THE LAW APPLY TO?

The Heart Legislation applies to a "Covered Expatriate," which includes certain US citizens and green card holders.

A "Covered Expatriate" only includes those US citizens and green card holders seeking to expatriate who have

(i) a net worth of at least $2 million on the date of expatriation or

(ii) an average annual net income tax for the five tax years prior to expatriation greater than $139,000 (this amount adjusts periodically for inflation).

MUST "CERTIFY OUT"

BEWARE: Notwithstanding the foregoing, even if the US citizen or green card holder does *not* have such a net worth or income tax liability, if they fail to certify under penalties of perjury that they have been compliant with the US tax laws for the 5 year period prior to expatriation, they will *also* be a Covered Expatriate and subject to the rules.

Therefore, even if the US citizen or green card holder seeking to expatriate does *not* have significant wealth which meets or exceeds the net worth or income tax thresholds, the expatriation rules will *still* apply - absent a certification under penalties of perjury.

A green card holder will only be subject to the expatriation rules and thus a Covered Expatriate if he or she has been a permanent US resident for at least 8 of the 15 years prior to expatriating including the year of expatriation.

BEWARE: It is important to note that so long as the individual holds a green card for one day in a calendar year, the year will count towards the 8 years. However, even if an individual has a green card, if the individual can be classified as a resident of a foreign country for any year during the fifteen year period through a treaty tie breaking provision, then such individual would be deemed *not* to be a US resident for such year.

EXEMPTIONS:

There are exceptions for two types of US citizens who, if they expatriate, are exempt from the expatriation rules:

(1) Individuals who became dual citizens at birth can be exempted. In order to qualify for the exemption:

(i) the individual must have obtained US citizenship solely by reason of birth as well as citizenship of another country,

(ii) at the time of the expatriation the individual must remain both a citizen and income tax resident of the other country, and

(iii) the individual must not have qualified as a US resident under the substantial presence test for more than 10 years out of the 15 year period ending with expatriation.

(2) Certain children can be exempt. These are children who expatriate

(i) before attaining the age of 18 1/2 and

(ii) who did not qualify as a US resident under the substantial presence test for more than 10 years out of the 15 year period ending with expatriation.

It should be noted that these exceptions are limited to children who are US citizens; there is no similar exception for children who were long term residents. Consequently, if a child who has a green card was in the US at least 8 out of the 15 years prior to expatriating and failed any of the requirements (i.e., income tax, net worth, or certification), such child would be subject to the expatriation rules of 877A, and the mark-to-market exit tax.

HOW TO EXPATRIATE?

Simply leaving the US even with the stated intent of never returning is **not** sufficient to expatriate. There is a process that must be followed in order to properly expatriate, which differs based upon whether the Covered Expatriate is a citizen or long term resident.

The process requires the Covered Expatriate to terminate his or her US status for immigration purposes.

The term "expatriation date" is the date on which an individual relinquishes his or her citizenship or, for a long term resident, the date on when such resident ceases to be classified as such "Expatriation Date".

A US citizen's Expatriation Date will be the *earliest* of the following four dates:

(i) when the individual renounces US nationality before a diplomatic or consular officer of the US pursuant to paragraph (5) of section 349(a) of the Immigration and Nationality Act;

(ii) the individual furnishes the State Department a signed statement of voluntary relinquishment of US nationality conforming with paragraph (1), (2), (3) or (4) or section 349(a) of the Immigration and Nationality Act;

(iii) the State Department issues a certificate of loss of nationality; or

(iv) a US court cancels a citizen's certificate of naturalization.

Steps 1 and 2 must be confirmed by the State Department issuing a certificate of loss of nationality.

Unless and until the State Department approves the expatriation, the Expat will remain a US citizen, and will be subject to US tax on worldwide assets.

However, at such time as the expatriation is accepted, the Expatriation Date will be the date when the individual renounced such citizenship in front of the consular or director officer.

A permanent long term resident's Expatriation Date will be on the date on which the individual loses his or her green card status through revocation or it has been administratively or judicially determined to have been abandoned.

Filing *Form I-407, Abandonment of Lawful Permanent Resident Status*, is equivalent to surrendering the green card and having it administratively terminated.

In the event the permanent long term resident never loses his or her green card, such individual will cease to be treated as a lawful permanent resident if:

(i) the individual begins to be taxed as a resident of a foreign country under a tax treaty between the US and the foreign country,

(ii) does not waive the benefits of the treaty applicable to residents of the foreign country; and

(iii) notifies the IRS of the commencement of foreign residency under the treaty.

INCOME TAX CONSEQUENCES OF EXPATRIATING

The focal point of the Heart Legislation is the mark-to-market exit tax, which subjects Covered Expatriates to tax on the net unrealized gain in their property.

The property is deemed sold on the day *before* the Expatriation Date.

To the extent to which the gain exceeds $600,000, the Covered Expatriate will pay a tax.

If the Covered Expatriate is deemed to be the owner of a trust under the grantor trust rules, then *all* of the assets held by the trust, and which the Covered Expatriate is deemed to own, shall be subject to the mark-to-market tax.

Covered Expatriates are deemed to have received a distribution of their *entire* interest in an IRA and other tax deferred accounts on the day before their Expatriation Date (no early distribution penalty tax would apply), and appropriate adjustments would be made to subsequent distributions from the account to reflect such treatment.

For purposes of determining the gain, no other Code provisions are applicable, and the time periods provided by any Code provisions, which permit a taxpayer to reduce the amount of gain recognized by acquiring property, terminate on the date before the Covered Expatriates Expatriation Date.

Additionally, any time periods which provide taxpayers with an extension to pay tax cease to apply.

The tax will be due and payable at the time and manner as prescribed by the IRS. The rules for determining loss contrast with those for determining gain as loss is determined in accordance with other Code provisions, except for the wash sale rules of IRC 1091, which do not apply.

Subsequent gains and losses that are recognized will be adjusted for the gains and losses recognized under the deemed sale rules, without regard to the $600,000 exemption.

The basis of the property owned by a Covered Expatriate who was a green card holder prior to expatriation is stepped-up such that the basis is no lower than the fair market value of the property on the date the Covered Expatriate first became a US resident.

The Covered Expatriate may make an irrevocable election to avoid the application of this basis step-up rule.

If the act of expatriating would generate a tax under IRC 684, the exit tax is applied after the application of IRC 684. Generally, IRC 684 requires a US person to recognize tax when appreciated property is transferred to either a foreign trust, or a foreign estate.

The transfer is treated as a sale or exchange in an amount equal to the fair market value of the property transferred. It should be noted that under current law, these rules will also apply when a US person transfers appreciated property to an non-resident alien, but there is an exception for transfers that utilize the US person's gift tax exemption.

PROVISION TO DEFER PAYMENT OF TAX:

A Covered Expatriate may defer payment of the exit tax in exchange for providing security to the IRS that satisfies 877A(b)(4).

While the payment of tax is deferred "until the due date of the return for the taxable year in which such property is disposed of (or, in the case of property disposed in a transaction in which gain is not recognized in whole or in part, until such other date as the Secretary may prescribe)," interest is charged during the deferral period at the rate applicable to underpayments.

The deferral cannot extend beyond the due date on which an estate tax return would be due for the Covered Expatriate, or earlier if the security no longer meets the requirements of the IRS.

The election to defer tax can be made on a property-by-property basis, and is irrevocable once made.

However, in order to elect deferral, the Covered Expatriate must provide the IRS with adequate security and waive any treaty rights that would preclude assessment or collection of tax.

Adequate security includes a bond accepted by the IRS, which is conditioned upon the payment of tax, and interest, and meets the requirements of IRC 6325.

Additional forms of security may be accepted, such as a letter of credit, provided they meet requirements set by the IRS.

SPECIAL RULES FOR INTERESTS IN NQDC AND NON-GRANTOR TRUSTS:

While most property owned by a Covered Expatriate is subject to the mark-to-market exit tax, there are two types of property that are excluded. These properties include certain interests in deferred compensation plans and non-grantor trusts. For Covered Expatriates who have an interest in certain deferred compensation plans or non-grantor trusts, instead of an exit tax, there is a withholding obligation imposed on third parties who deal with a covered expatriate. This withholding replaces any withholding that would have otherwise been required under the Code. The third parties, as discussed below, must be U.S. persons, and are required to withhold 30% of any distribution to a Covered Expatriate.

For purposes of distributions from a deferred compensation plan, this withholding obligation only exists if the Covered Expatriate has an eligible deferred compensation interest.

An eligible deferred compensation item must have

(i) a payor who is a US person or elects to be treated as US person for purposes of the withholding,

(ii) a Covered Expatriate who notifies the payor of his or her status, and

(iii) the Covered Expatriate makes an irrevocable waiver of any rights to treaty benefits, which could reduce the tax.

Additionally, the deferred compensation plan must be based upon services the Covered Expatriate provided inside the US.

The withheld distribution to a Covered Expatriate from an eligible deferred compensation plan is subject to tax under IRC 871 provided such payment would have been included in the Covered Expatriates gross income had he or she remained a US citizen or green card holder.

This contrasts with the tax treatment of an interest in an ineligible deferred compensation plan.

If the item is *not* subject to tax under IRC 83, then "an amount equal to the present value of the Covered Expatriate's accrued benefit shall be treated as having been received" by the Covered Expatriate on the day before the

Expatriation Date, and subject to the exit tax.

If the item *is* subject to tax under IRC 83, then the item is treated as no longer subject to the substantial risk of forfeiture on the day before the Expatriation Date.

Appropriate adjustments need to be made to subsequent distributions from the plan to reflect that the risk no longer exists, and the early distribution tax will not apply to these deemed distributions.

When a non-grantor trust makes a distribution, whether director or indirect, to a Covered Expatriate, the trustee is required to withhold 30% of the distribution. Needless to say, there are questions as to how the IRS can enforce this requirement when there is a foreign trustee of a foreign trust, and there is no U.S. nexus.

The portion of the withheld distribution is subject to tax under IRC 871 provided such payment would have been included in the Covered Expatriates gross income had he or she remained a US citizen or green card holder.

This withholding obligation only exists if the Covered Expatriate was a beneficiary of the non-grantor trust on the day before the Expatriation Date.

The Covered Expatriate is deemed to have made an irrevocable waiver of any rights to treaty benefits, which could reduce the tax, which is contrary to the requirement in the deferred compensation setting where the Covered Expatriate must affirmatively make a waiver.

If the non-grantor trust distributes appreciated property to the Covered Expatriate, the trust must recognize gain as if the property was sold to the Covered Expatriate at its then fair market value.

If a Covered Expatriate is deemed to become the owner of a non-grantor trust subsequent to expatriating, this will be viewed as a conversion and treated under 877A(f)(1) as a distribution to the Covered Expatriate in an amount equal to the value of the property he or she is deemed to own under the grantor trust rules.

TRANSFER **TAX CONSEQUENCES OF EXPATRIATING**

New IRC 2801 applies to *covered gifts* and *covered bequests* from Covered

Expatriates.

A covered gift is defined as any property acquired by gift directly or indirectly from an individual who is a Covered Expatriate at the time the gift is received. A covered bequest is defined as any property acquired directly or indirectly by reason of death from an individual who was a Covered Expatriate immediately before death. The relevance of these terms is that the new legislation taxes the US *recipient* of a gift or bequest from a Covered Expatriate.

The tax is equal to the product of the highest estate or gift tax in effect at the time of receipt and the value of the gift or bequest.

It should be noted that the legislation does *not* contain an exemption for property obtained by a Covered Expatriate subsequent to the Expatriation Date - *even* if it is foreign situs property.

Thus, the gift or bequest of *any* asset from a Covered Expatriate to a US person subjects the US *recipient* to tax.

EXCEPTIONS AND LIMITATIONS:

If a charitable *or* marital deduction *would* have been available - had the donor or decedent been a US person - then the gift or bequest will *not* be considered a covered gift or bequest.

Similarly, if the donor or decedent reflects the gift or bequest on a timely filed US gift tax return or estate tax return, and tax is paid, then the US recipient of the gift or bequest will not have to pay tax on the receipt of property.

The tax imposed on the US recipient will be reduced by any foreign gift or estate tax paid by the donor or decedent.

Finally, only covered gifts or covered bequests in excess of the then annual exclusion will be subject to tax.

When a covered gift or covered bequest is made to a domestic trust, the trust will be classified as a US citizen. As such, the *trust* will be required to pay the corresponding gift or estate tax.

If the covered gift or covered bequest is made to a foreign trust that has any US beneficiaries, gift or estate tax will be due when a distribution is made to the US beneficiary.

The US beneficiary is able to deduct the tax for income tax purposes to the extent tax is imposed on the distribution that is included in the US beneficiary's gross income.

The trustee of a foreign trust can elect to have a foreign trust treated as a domestic trust solely for purposes of IRC 2801, which could assist the US beneficiaries with tax reporting. However, once such an election is made, it cannot be changed without the government's consent.

EFFECTIVE DATE:

The rules dealing with covered gifts and covered bequests apply to all gifts or bequests received from a Covered Expatriate who expatriated *after* June 16, 2008.

Covered Expatriates are subject to U.S. estate tax on their US situs assets, are provided an exemption from US estate tax on the first $60,000 of their US situs assets, and may benefit from the marital deduction and the charitable deduction. Consequently, they are subject to estate tax in much the same way as a non resident-not a citizen.

However, when a non resident-not a citizen transfers non US situs property to a US person, there is no GST tax as the GST tax is imposed on a transfer of property from a non resident-not a citizen only if the transfer is subject to federal gift or estate tax. As a result of the Heart Legislation subjecting the US recipients of covered gifts and covered bequests to gift and estate tax, it would appear that Covered Expatriates will no longer be able to transfer non US situs property free of GST tax.

COMMENT:

If an individual makes the decision to expatriate, he or she will face the potential financial consequences of their choice.

However, third parties may also incur liability depending upon whether the Covered Expatriate makes gifts or bequests to US family.

Consequently, US tax professionals should pay close attention to whether any of their clients have family members who have or will expatriate because the US client may have increased compliance obligations. For example, US persons would be required to file Form 3520 to report (i) outright gifts, (ii) distributions from a trust, or (iii) bequests from the Covered Expatriate.

The US persons may also have to pay gift or estate tax on the receipt of the distribution or bequest.

An often overlooked filing requirement is the TD F 90-22.1, which may also be required by US persons who inherit or receive an interest in a foreign account.

HOPE THIS HELPS YOU HELP OTHERS MAKE A POSITIVE DIFFERENCE!

Kevin Packman

CITE AS: