ONLINE EDITION
JERUSALEM POST

Your Taxes: American olim may want to continue to pay US taxes

Jul. 30, 2008
KEVIN PACKMAN and LEON HARRIS , THE JERUSALEM POST

The Knesset Finance Committee is currently debating the Aliya Tax Reform bill, a major piece of legislation that will have far-reaching effects for anyone making aliya.

The bill is designed to encourage at least 60,000 people to make aliya or return to Israel by giving olim a 10-year tax exemption for all types of foreign-source income and capital gains derived personally or via a foreign resident company.

From the perspective of the IRS, a US citizen or green card holder who makes aliya remains subject to US income tax on their worldwide income. To help avoid double taxation, foreign tax credits are available in both countries and under the US-Israel tax treaty. For some US taxpayers the tax credits are insufficient and they wish to cease paying US tax altogether by means of "expatriation" - abandoning their US citizenship or green card.

The financial consequences of expatriating were significantly changed last June, when President Bush signed the "Heroes Earnings Assistance and Relief Tax Act of 2008 (known as the "HEART Legislation"). This legislation provides numerous benefits to US war veterans at an approximate price tag of $1.2 billion. To help offset the cost, individuals who expatriate from the US ("Covered Expatriates") will now incur an exit tax. Furthermore, US recipients of gifts and bequests from such Covered Expatriates will now incur gift and estate tax. The Heart Legislation became effective as of June 17, 2008, and introduced new US Internal Revenue Code Sections 877A and 2801 (hereinafter referred to as Code Sections). Following is a brief overview of certain aspects of the legislation.

Who is caught by the law?

The Heart Legislation applies generally to a "Covered Expatriate" who has: a net worth of at least $2 million on the date of expatriation, OR an average annual net income tax for the five tax years prior to expatriation greater than $139,000 (this amount adjusts periodically for inflation).

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.

A green card holder will only be considered 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.

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 (for example, under Article 3 of the US-Israel tax treaty), then such individual would be deemed not to be a US resident for such year.

Are there any exemptions?

There are exceptions for two types of US citizens who, if they expatriate, are exempt from the expatriation rules which may be potentially relevant to some readers.

First, individuals who obtained dual citizenship (for example the US and Israel) *at birth* can qualify for the exemption. In order to qualify for the exemption:

• The individual must have obtained US citizenship solely by reason of birth as well as citizenship of another country (such as Israel),

• At the time of the expatriation the individual must remain both a citizen and income tax resident of the other country (such as Israel), and

• 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.Under this test, you are considered US resident in a year if you are physically present in the United States for 183 days in any year, or 122 days for three consecutive years. (The test works out that all the days you were present in the current year count as full days, days present in the immediately preceding year count as 1/3 days, and days in the second preceding year counts as 1/6).

Second, certain children are also exempt.These are children who expatriate before attaining the age of 18 1/2 *and* who did not qualify as US residents 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.

How to expatriate from the US

Simply leaving the US, even with the stated intent of never returning is *not* sufficient to expatriate. The process requires the Covered Expatriate to terminate his or her US status for immigration purposes.

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

• When the individual renounces US nationality before a diplomatic or consular officer of the US

• The individual furnishes the State Department a signed statement of voluntary relinquishment of US nationality

• The State Department issues a certificate of loss of nationality; or

• A US court cancels a citizen's certificate of naturalization.

Unless and until the State Department approves the expatriation, the "Covered Expatriate" 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.

US 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. To the extent the gain exceeds $600,000, the Covered Expatriate will pay a tax. Assets held more than 12 months qualify for capital gains treatment (generally 15%), and those that were held for less than 12 months are subject to tax at ordinary income tax rates. The property is deemed sold on the day before the Expatriation Date. Therefore, the US-Israel tax treaty cannot reduce the exit 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. The tax will be due and payable at the time and manner as prescribed by the IRS.

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

Can the exit tax be deferred?

A Covered Expatriate may defer payment of the exit tax in exchange for providing security to the IRS that satisfies Code Section 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 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.

Tax on gifts and bequests

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 - even if it is foreign situs property. Currently, federal US gift and estate tax rates range up to 45%.

The tax imposed on the US recipient will be reduced by any foreign gift or estate tax paid by the donor or decedent. Israel does not tax inheritances but it does impose capital gains tax on the value of assets gifted by Israeli residents to non-Israeli residents.

To sum up: If an individual makes the decision to expatriate by relinquishing US citizenship or a green card, the immediate and subsequent US tax consequences may be significant. Consequently, the choices need to be reviewed carefully. Many US Olim may prefer to remain US taxpayers after all (!!) and rely on foreign tax credit rules to help avoid double taxation.

As always, consult experienced tax advisors in each country at an early stage in specific cases.

kevin.packman@hklaw.com, leon.harris@il.ey.com

Kevin E. Packman, Adv., is a tax specialist with Holland & Knight, Miami.

Leon Harris is an International Tax Partner at Ernst & Young Israel