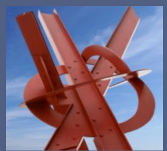
New Haven

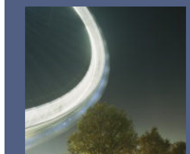
New York

Geneva

Greenwich



London



Milan

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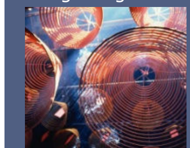

EXPATRIATION TAX AND PLANNING

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Expatriation Tax and Planning

- Why the interest in expatriation?
- Overview of Expatriation Legislation Attempts Prior to 2008
- Expatriation after June 17, 2008
  - Section 877A
  - Section 2801
- Expatriation Procedures and Reporting
- Planning for Tax Effects of Expatriation
- Non-Tax Limits on Expatriation?

Why the Heightened Interest in Expatriation?

- 3000 people expatriated in 2013 (221% increase from 2012)
  - Actual number may be quite higher
  - FATCA effective dates in July, 2014
  - OVDI initiatives US and abroad
  - Dramatic increases in US and State income tax rates
  - Some asset values still depressed

Why Do Individuals Care? US Tax Principles

- US CITIZENS AND GREEN CARE HOLDERS TAXED ON WORLDWIDE BASIS
  - US income taxation on worldwide income and gains
  - US estate and gift taxation on worldwide property
  - Look-through taxation of income in controlled foreign corporations; application of other anti-deferral regimes
- NONRESIDENT ALIENS TAXED ON TERRITORIAL BASIS
  - US income taxation
    - 30% withholding tax on US source passive financial income
    - US trade or business income subject to tax at marginal rates
    - Gains on sales of US assets (except US real property) generally not taxed
  - US estate taxation
    - Only applies to US situs property
    - US securities taxable
    - Bank deposits and portfolio interest instruments excluded
  - US gift taxation
    - Only applies to gifts of US real property and tangible personal property
    - US securities excluded

A Little Historic Perspective

- First expatriation provision added with FITA in 1966
  - Sections 877 and 2107 but no gift tax provision
    - 10 year alternative tax scheme
    - Applicable to US citizens only
- HIPAA revised rules in 1996
  - Expatriation 10 year rules apply if expatriation had tax avoidance purpose (rulings available)
  - Applicable to US citizens and long term US Green card holders
    - Additional gift tax rules added

A Little Historic Perspective (Cont)

- U.S. expatriation tax regime continued in flux during the last decade; major changes in each of years 2001, 2004 and 2008
- Pre-2008 high net worth expatriates always were subject to special U.S. income and transfer tax rules and reporting for a 10-year period following expatriation (Alternative Tax Regime)
- Heroes Earnings Assistance and Relief Tax Act of 2008 repealed the 10-year regime and imposed an “Exit Tax”
  - Exit Tax is a one-time charge on the appreciation of an expatriate’s worldwide assets
  - Expatriates remain subject to U.S. gift and estate taxes on gifts or bequests to U.S. persons (essentially an inheritance tax)

Section 877A Replaced Section 877 with Effect From June 17, 2008

- Applicable to Citizens and Long Term Green Card Holders Who "Expatriate"
  - Citizens – Can only expatriate by renouncing citizenship
  - Green Card Holder (held Green card in 8 of last 15 years)
    - Can cease to be long term resident if:
      - Relinquishing Green Card
      - Revocation of status
      - Judicial or administrative determination of abandonment
      - Form 8833 filing with closer connection claim to foreign country under treaty

Applicable Only to "Covered Expatriate"

- US citizens or long term permanent residents who meet one of the following three tests
  - i) Net Worth Test -$2,000,000 or greater (no indexing)
  - ii) Income Tax Liability Test – Average US income tax liability for last five years exceeds $157,000 (indexed for inflation); or
  - iii) Failure to certify compliance with all US tax requirements for past 5 years (Form 8854)

Exceptions To “Covered Expatriate” Status

- Dual Citizen at Birth
  - Continues to be a citizen of, and taxed as a resident in, that other country as of the expatriation date and
  - Has been income tax resident in the US (based on the substantial presence test) for no more than 10 of the past 15 years
- Minors
  - Not a Covered Expatriate if relinquishing US citizenship before reaching age 18 ½ and US income tax resident (based on the substantial presence test) for not more than 10 taxable years
- Re-Establishment of Residence
  - Not a Covered Expatriate for any period during which subject to income tax as a resident of the US

Income Taxation of Covered Expatriates at Expatriation

- Exit or "Mark-to-Market" Tax
  - Expatriate deemed to have sold all property for fair market value on day before expatriation with net unrealized appreciation subject to US income tax
    - Exemption of first $680,000 of gain (2014 number indexed for inflation)
  - Following expatriation, a Covered Expatriate continues to be subject to 30% withholding tax on distributions from:
    - Certain deferred compensation arrangements, and
    - Non-grantor trusts (defined as any trust of which the expatriate is not considered the owner immediately before expatriation)

Mark to Market Taxation Under Section 877A

- Tax measured on net mark to market gain minus $680,000
- Gain determined by appraisal using estate tax valuation principles (net worth test uses gift tax principles)
- Exemption is allocated proportionately against all mark to market items
- Tax at normal rates per asset and holding period
- Exemptions for: Interests in non-grantor trusts
  Deferred compensation items
  Certain tax deferred accounts

What Assets are Included in Mark to Market Base?

- Assets includible for estate tax purposes
- Assets in grantor trusts deemed to be "owned" by Covered Expatriate
- All grantor trusts?
  - Conflict of authority but likely not
  - JCT/Notice 2009-85
- Deferred compensation values

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Assets Not Subject to Mark to Market Tax

- Non-Grantor Trusts
  - Taxable portion of distribution subject to 30% withholding tax
  - Trustee must withhold at time of distribution
  - Covered Expatriate may elect mark to market at expatriation date if value of trust interest is determinable
  - Not applicable to foreign grantor trusts as no portion is taxable to US Covered Expatriate

Certain Assets Not Subject to Mark to Market Tax

- Deferred Compensation if “Eligible”
- “Eligible” only if US payor (or foreign payor elects as such)
  <u>and</u>
  Covered Expatriate waives any treaty benefits
- If “Eligible” 30% withholding at time of payment

Ineligible Deferred Compensation Taxed at Date of Expatriation

- Statutory and non-qualified stock options
- SARs
- IRAs
- Previously untaxed Section 83 Property
- Taxed at current balance on expatriation date or discounted present value depending on type of deferred compensation
- Vesting and substantial risk of forfeiture is ignored

Transfer Taxation of Certain Gifts or Bequests Made By Covered Expatriates Following Expatriation

Section 2801

New "Donee Tax" on gifts or bequests by Covered Expatriate to a US person or trust following expatriation:

- Exceptions for gifts to qualified charity or US citizen spouse
- Applies also to distributions to a US person from a foreign trust established by the Covered Expatriate
- Direct and indirect transfers included (conduit rules?)

Section 2801 Principles

- Covered gift or bequest to US person taxed to recipient at highest transfer tax rate (40%)
- Assets transferred can be totally unrelated to assets at expatriation
- Exceptions
  - Annual exclusion gifts ($14,000 or less)
  - FMV transactions
  - Qualified Charities
  - US Spouses
  - No extra GST tax

Gifts or Testamentary Transfers by Covered Expatriates to Trusts

- Taxed immediately if to US domestic trust
- Tax on receipt by US person if distributed from foreign trust
- Foreign trust can elect to be treated as US trust
- Additional income taxes may also apply if foreign trust is non-grantor trust

Anomalies With Respect to Section 2801

- 2801 tax is akin to an inheritance tax but net gift rules do not apply
- Tax applies to all property transferred by Covered Expatriate or his estate to US persons
- Tax is not related to property value of Covered Expatriate at time of expatriation
- Tax does not apply if gift or estate transfer is otherwise taxable – issues of US situs property or US domicile
- No “QDOT” Corollary

Expatriation Procedures

- US Citizen
  - Must formally renounce at US embassy
  - Each embassy has slightly different procedures
  - Check with embassy as to
    - Eligibility
    - Timing
    - Interviews
    - Required Paperwork

Expatriation Procedures

- Long term US Green Card Holder
  - Filing Form 1-407 with physical surrender of Green Card
  - Watch Green Card expiration traps as it may have expired but still may be a Covered Expatriate
  - Ceasing to be long term permanent resident if closer connection claim to foreign jurisdiction

Planning Opportunities

- Failure to qualify as Covered Expatriate
  - Income Test based on approximately $500,000 income
    - Defer current income or expatriate before extraordinary tax event
    - Married filing separately
    - Foreign tax credit planning
    - Gifting low basis property
    - Disclaiming grantor trust status

Planning Opportunities

- Net Worth Test based on $2,000,000 net worth
  - Pre-expatriation gift-planning – low basis assets
  - Eliminating interests in trusts by exclusion or disclaimer
  - Spousal gifts
  - Valuation discount planning

Planning Opportunities

- Property Sales
  - Allocation of Exemption Amount
  - Reduction of Net Worth by Tax Payments
  - Actual sales permit basis uplift in new country whereas mark to market may not
  - Sell low tax rate assets to force exemption allocation to high tax rate assets (recapture, collectibles)

Planning Opportunities - Section 2801 Tax

- Net gift taxation of US situs assets
- Valuation discount planning
- Redomicile to the US for income tax purposes but not for transfer tax purposes
- Beware the US domiciled non-citizen spouse
- Present interest gifts
- Conduit gifts (?)

Non-Tax Limits on Expatriates

- The Reed Amendment
  - A former US citizen is ineligible for admission to the US if US AG determines former US citizen surrendered citizenship for tax avoidance purposes
  - Significant problems with enforcement and to date not applied
- The Ex-PATRIOT act (the “Saverin Bill”)
  - Could apply to any covered person who had expatriated up to 10 years prior to date of enactment
  - “Specified Expatriates” must pay 30% tax on any US-sourced capital gains (Old 877 concept)
  - Would bar a Specified Expatriate from <u>ever</u> reentering the United States unless proof that expatriation did not substantially reduce taxes.

Questions? Comments?

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