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Breaking Up Is Hard To Do: Why Expatriating From The US Requires Careful Tax Planning

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Congratulations! Your client has won the "lottery." In this case, his grand prize is a green card. Before he collects his winnings, there are important US tax consequences for him to consider if circumstances should change in the future and his US permanent residency is no longer desirable. For the high-net worth global client, making a change in his or her residency may seem as straightforward as ordering a trade in his or her investment portfolio. In reality, without proper US tax planning, expatriation can be costly. In order to achieve maximum flexibility for your international clients, seeking the advice of qualified US tax counsel early on is key. Otherwise, your clients may find that breaking ties with the US comes at a high price.

The United States has a long history of disincentivizing US taxpayers from expatriating through various tax-related mechanisms. Currently, there are two different US tax regimes which operate simultaneously to penalize US taxpayers, and certain US family members of those US taxpayers, for terminating their US residency. On the US income tax side, there is the "exit tax" regime and, from a US transfer tax perspective, there is the "inheritance tax" charge (collectively, these regimes will be referred to as the "US expatriation tax regimes"). Only certain expatriates are subject to the US expatriation tax regimes. The application of these rules turns on whether the US taxpayer at issue is a "covered expatriate" at the time of his or her expatriation.

A person is an "expatriate" if he or she is a US citizen who relinquished his or her US citizenship at any time or a US permanent resident who relinquished his or her US permanent residency status after maintaining such status for 8 of the last 15 years (also known as a "long-term permanent resident"). A long-term permanent resident may unwittingly expatriate by moving to a

jurisdiction with which the United States has an income tax treaty and taking a position that he or she is a resident only of the other jurisdiction under that treaty. Accidental expatriations of this nature are quite common and can occur even if consistent US tax filings are not made contemporaneously. It is therefore crucial for high-net worth clients to seek competent US tax advice in advance of any move outside of the United States even if their goal is not to exit the US tax net.

Once a determination has been made that an expatriation has occurred, the expatriate will be subject to the US expatriation tax regimes only if he or she meets one of several tests. The first of these tests is the "tax liability test." The tax liability test is met if an expatriate has an average net US income tax liability of greater than USD161,000 (indexed for inflation) for the five taxable years ending prior to the expatriation date. The second test is the "net worth test," which is met if the expatriate's net worth as of his or her expatriation date is USD2m or more. The final test is the "tax compliance certification test," which is met if the expatriate fails to certify compliance with his or her US tax obligations for the five years prior to expatriation under penalty of perjury.

Narrow exceptions are provided for certain dual citizens from birth and minors, but only if such person is considered a covered expatriate by reason of meeting the tax liability test or the net worth test. Because exceptions are not provided for individuals who fail to certify their US tax compliance for the five years prior to expatriation, regardless of the result under either the tax liability test or the net worth test, many planning projects in the expatriation context may need to begin with a clean-up of an individual's prior tax non-compliance to ensure that the US expatriation tax regimes do not apply to such person. In these cases, having the US tax compliance and planning aspects of the project coordinated from the start can save a client significant time and fees.

If your client is considered a covered expatriate, then from a US income tax point of view, he or she will be subject to the exit tax regime. Under the exit tax regime, a covered expatriate is subject to a mark-to-market US income tax charge on the vast majority of his or her assets worldwide. The deemed sale is treated as occurring on the day before an individual's expatriation date. Any built-in gain from the deemed sale of assets is recognized for US income tax purposes notwithstanding any other non-recognition rules which otherwise would apply to defer to the tax. A covered expatriate is entitled to exclude only USD693,000 (adjusted for inflation) of the gain recognized from the deemed sale of his or her worldwide assets.

Certain assets of a covered expatriate escape US income tax taxation under the exit tax regime. These interests are still trapped within the US tax system, however. Deferred compensation items,

specified tax deferred accounts and interests in nongrantor trusts[1] are subject to a withholding tax regime. A covered expatriate is subject to a 30 percent gross basis withholding tax when a taxable amount is eventually paid or distributed to him or her. Depending upon the amount of built-in gain on assets held by a trust, a high-net worth client may be better off expatriating while holding an interest in a grantor trust[2] which will be subject to the exit tax rather than an interest in a nongrantor trust which will be subject to the 30 percent withholding tax instead. Alternatively, holding an interest in a nongrantor trust may be preferable if the future beneficiaries of your client's share of the trust are his or her US children.

In contrast to the exit tax rules, the more recently enacted US inheritance tax charge is a 40 percent flat tax applicable to certain US individuals who receive gifts or bequests at any time from a covered expatriate which exceed USD14,000 (indexed for inflation) during a calendar year. To be clear, the US inheritance tax charge is levied on the recipient. Additionally, the US inheritance tax charge applies regardless of the amount of time which elapses between a covered expatriate's date of expatriation and the subsequent gift or bequest to a US domiciled recipient. It is important to note that a domestic trust[3] is treated as a US person for purposes of the inheritance tax charge. US recipients of distributions from foreign trusts[4] are also subject to the inheritance tax charge to the extent these distributions are attributable to gifts or bequests made by a covered expatriate to the foreign trust.

Exceptions to the US inheritance tax charge are provided for gifts by a covered expatriate which are reported on a timely filed gift tax return, bequests which were included in the gross estate of the covered expatriate and reported on a timely filed estate tax return, and certain qualifying gifts or bequests made to a US spouse or a qualified charity. The exceptions create a "pick your poison" scenario under which the covered expatriate with US children either retains the US transfer tax exposure by choosing not to expatriate or passes it on to his or her US children when they receive gifts or bequests from him or her in the future. Relief is granted in the form of a credit for any gift or estate taxes paid to a foreign country which may be useful in certain cases depending upon several factors including the laws of the jurisdiction in which the heirs of the covered expatriate are residing at the time of their receipt of the assets.

Other than the statutory credit, US domiciled recipients of gifts or inheritances from covered expatriates may be without recourse. Even though the United States has several transfer tax treaties in force, it is unclear that treaty benefits can be claimed with respect to the US inheritance

tax charge. The US tax law provides that, in the event of an inconsistency between the provisions of a treaty and a statute, the provision enacted later in time prevails. US courts, however, have viewed this principle of interpretation as one of last resort to be invoked only when the language of a statute and the provisions of a treaty cannot be harmonized or construed in a way that gives proper effect to each one. Even if the provisions of a statute clearly contradict the terms of an existing treaty, US courts may be hesitant to apply the later in time rule absent clear Congressional intent for the statute to supersede a prior obligation of the United States to its treaty partner.

Unfortunately, Congress did not make it clear when enacting the inheritance tax statute whether the inheritance tax charge was meant to override existing transfer tax treaty obligations of the United States. In fact, the legislative history seems only to add to the confusion. Congress believed that, where US gift or estate taxes are avoided with respect to transfers to a US person by reason of the expatriation of the donor, it was appropriate for the recipient to be subject to an income tax based on the value of the property. Yet, the inheritance tax is clearly part of the US gift and estate tax rules and, in the same legislative history, it is simultaneously described as a transfer tax.

While Proposed Treasury Regulations on the inheritance tax have been issued, the Examples are of limited use. Interestingly, they focus on the fact that the covered expatriate is domiciled in a country with which the United States does not have a transfer tax treaty, even though the inheritance tax is charged to the recipient. Complex issues may arise in this context since US gift and estate taxes, and the transfer tax treaties which address them, relate to a US tax obligation that is imposed on the donor and not one that is levied on the recipient. Until further guidance is forthcoming, it remains unsettled whether transfer tax treaty benefits are available with respect to the inheritance tax charge.

In spite of the seemingly broad application of the US expatriation tax regimes, nuances exist and in certain cases may present significant opportunities for creative tax planning. Of particular interest is the net worth test. In IRS guidance, it is made clear that an individual is deemed to own any interest in property that would be taxable as a gift for US gift tax purposes if such individual was domiciled in the United States and transferred such interest immediately prior to expatriating. Interestingly, however, a special rule is provided for purposes of determining an individual's beneficial interest in a trust. Pursuant to this IRS guidance, an individual's interest in a trust is determined under a two-step process. First, all interests in property held by the trust are allocated to the beneficiaries based on all relevant facts and circumstances, including historical patterns of distributions. Interests in property that cannot be allocated to the beneficiaries based upon these

factors must be allocated under the principles of intestate succession determined by reference to the settlor's intestacy. Second, any property which is allocated to the expatriate then must be valued under general gifting principles without regard to any restrictions or prohibitions.

It seems clear that only an individual who is a beneficiary or potential beneficiary of a trust has a beneficial interest that counts for purposes of the net worth test. Arguably, individuals who were once beneficiaries of a trust but who, at the time of their expatriation, have no beneficial interest in the trust should not be required to include anything in relation to the trust in the determination of their net worth. Additionally, assuming there is a discretionary trust from which no distributions have been made, allocating beneficial interests in the trust in accordance with principles of intestate succession by reference to the settlor's intestacy would seem to preclude the settlor from having any beneficial interest allocated to him or her since one cannot inherit from himself or herself. The trust may need to be located in an asset protection jurisdiction for this result.

While the IRS guidance makes no distinction between foreign and domestic trusts, it is important to note that an expatriate (regardless of whether he or she is a covered expatriate) likely will prefer a domestic trust in the event of an expatriation. There is a separate and unrelated rule in the US tax law which subjects many US taxpayers who are deemed to transfer property to a foreign trust to a mark-to-market exit tax at the time of the transfer. Because this rule does not apply to transfers to domestic trusts, the highly mobile client may prefer to create a domestic trust or domesticate his or her foreign trust well in advance of any expatriation in the event circumstances change.

While the current personal exemption amount for US domiciliaries against US gift and estate tax is USD5.450m, Congress has evidenced its intention to penalize expatriates by limiting the net worth threshold for covered expatriate status only to USD2m. Because only covered expatriates are penalized for exiting the US tax system, planning to avoid this classification can be beneficial. For clients with significant wealth who are not US citizens and who are already living abroad, outright gifting may be enough to place them below the net worth threshold. Otherwise, more sophisticated trust planning techniques may be needed if your high-net worth client decides to expatriate. In these cases, it may be more advantageous from a reporting perspective for your client to consider creating a nongrantor trust since the level of disclosure required with respect to a grantor trust seems to be more extensive.

Even if there is no simple solution to reduce your client's assets below the net worth threshold or covered expatriate status is unavoidable, one may be able to take advantage of trust planning and

the vastly different rules which apply to grantor as opposed to nongrantor trusts under the exit tax regime to minimize the US income tax impact of expatriation. It is important to note that the test for determining whether a covered expatriate has an interest in a trust which is subject to the exit tax is slightly different than the test for determining whether an asset is counted for purposes of the net worth test. Once an individual is a covered expatriate, assets of a trust which would be included in the covered expatriate's gross estate for US estate tax purposes are subject to the exit tax. Additionally, even if property held by a trust would not be so included, the exit tax applies if the covered expatriate's interest in the trust can be determined and valued. Interestingly, the same principles which are used to ascertain if an expatriate has an interest in a trust for purposes of the net worth test also apply for this purpose. Under those principles, it is possible that none of the value of a trust may be allocated to the covered expatriate for purposes of the calculation of the mark-to-market exit tax.[5]

The type of trust that will be most useful to your client who would be a covered expatriate in these instances will depend on the nature of the assets that will be used to fund the trust. Since there is a 30 percent withholding tax on the taxable portion of distributions from a nongrantor trust to a covered expatriate, a grantor trust may be preferable. If the covered expatriate is not allocated an interest in a grantor trust, he or she will not be subject to US income tax on any built-in gain on the assets held by such trust under the exit tax and future distributions to him or her will not be subject to the 30 percent withholding tax either. For non-domiciled green card holders in particular, this type of grantor trust may save significant US income tax if the client is able to fund it with his or her low-basis assets sufficiently in advance of expatriating and any built-in gain on his or her assets outside of the trust is within the annual gain exclusion amount (indexed for inflation). Trust planning in these situations also can be advantageous if the covered expatriate has US domiciled children who otherwise would be subject to the inheritance tax on gifts or bequests from the covered expatriate.

Understanding the potential obstacles which a high-net worth client may face by expatriating will facilitate an advisor's ability to flag these potential issues and assist the client with obtaining competent US tax advice in advance of any residency change. Proper pre-expatriation planning can provide your peripatetic client and his or her US family members with significant US tax savings if and when the time comes for your client to make a clean break from the United States.

Endnotes

[1] A nongrantor trust is a separate entity for US tax purposes. Income generated by a nongrantor trust may be ultimately paid by the trust, the beneficiaries, or a combination of both.

[2] A grantor trust is a trust for which a person (such as the grantor) is treated as the owner of the assets of the trust and who is therefore treated as earning the income of the trust directly for US income tax purposes.

[3] A domestic trust is any trust for which both (a) one or more US persons have the power to make all substantial decisions concerning the trust (***e.g.***, to whom to make distributions, the power to remove the trustee, or the power to change the governing law) (the "control test") ***and*** (b) the jurisdiction for court supervision of the primary administration is within the United States (the "court test").

[4] A foreign trust is any trust which is not a domestic trust for US tax purposes.

[5] Additionally, in that case, none of the assets of the grantor trust would be disclosed on IRS Form 8854.