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Expatriation and the Ten Year Rule

Expatriates who left the U.S. prior to June 17, 2008 are covered under prior tax rules, contained in three separate Tax Acts, which each subject U.S. expatriates to a ten-year "alternative tax regime" on U.S. source income; i.e. for ten years after expatriation, the expatriate is required to file a U.S. income tax return, to report U.S. source income.

The Three Tax Acts

1. Foreign Investors Tax Act of 1966 (1966 Act), added IRC Sec. 877 to impose tax on the U.S. source income of former U.S. citizens who expatriated for a principal purpose of tax avoidance, for ten years following expatriation. These rules were subsumed into the 1996 Act.

1966 Act

2. Health Insurance Portability and Accountability Act of 1996 (1996 Act)

   This 1996 Act expanded the 1966 Act. Expatriates who left the U.S. prior to 2004 are covered for U.S. tax compliance purposes under the 1966 and 1996 Acts, for the period up through 2013 (i.e. 2003 plus ten years). This Act included a "presumptive tax avoidance purpose" if the expatriate's net average U.S. income tax liability was $100,000 or more, in the five years preceding expatriation, or his net worth at expatriation exceeded $500,000.

2004 Act (American Jobs Creation Act

The 2004 Tax Act covers expatriates who left the U.S. between 2004-2008 (through 6/16/08). Under this Act, expatriation commencing 2004, subjects the expatriate to U.S. income tax reporting through 2014 (2004 plus 10 years) on U.S. source income, expatriation up to 6/16/08, subjects the expatriate to U.S. tax reporting through 2018 (6/16/08 plus 10 years), on U.S. source income.

The 2004 Tax Act removed the requirement that an individual have a “principal tax avoidance purpose”. Instead, the presumptive tax avoidance purpose limits were included under the “income tax liability test” and this was changed to “greater than $124,000 (indexed annually beginning in 2005). The “net worth test” standard was increased to $2m (not indexed). The 2004 Tax Act added a third test, providing that the expatriate certify that he has fully complied with all U.S. tax requirements for the five years preceding expatriation.

<u>2008 Act</u> (<u>Heroes Earnings Assistance and Relief Tax Act</u>)

The 2008 Act repeals the 2004 Act, “alternative tax regime” (prospectively post-6/16/08), eliminates the 10 year forward tax reporting requirement. Instead, it imposes a “mark-to-market” tax (from a “deemed sale” of an individual’s world-wide assets, on the day prior to the expatriation date) on imputed gains on all assets in excess of $651,000 for 2012 (IRC Sec. 877A).

A “succession tax” (IRC Sec. 2801) paid by the U.S. recipient of a gift or bequest from a covered expatriate. Additionally, it imposes a 30% withholding tax on a covered expatriate’s receipt of:

(1) An eligible deferred compensation item (i.e. an interest in a qualified plan or other arrangement described in IRC Sec. 219(g)(5), interests in foreign pension, retirement or similar plans, any item of deferred compensation, interests in property to be received in connection with the performance of services not previously taken into account in accordance with the IRC Sec. 83. Deferred compensation attributable to services performed outside the U.S. while a covered expatriate was not a U.S. citizen or resident is not included. Tax on the payment of an “eligible deferred compensation

item" is deferred until a covered expatriate receives a taxable payment (i.e. a payment that would be taxable if the individual were a U.S. person), at which time tax is collected by means of a 30% withholding tax, withheld by the U.S. payor.

(2) In the case of deferred compensation items that are not eligible deferred compensation, an amount equal to the present value of an individual's account is treated as received and taxable on the day before expatriation (30% tax).

(3) "Specific Tax Deferred Account" (i.e. IRA, Education & Health Savings Account) is treated as distributed on the day before expatriation (and taxed at 30% on the present value of the account).

(4) <u>Non-Grantor Trust</u>: The trustee shall withhold tax at 30% from the taxable portion of a direct or indirect distribution from a non-grantor trust to a covered expatriate.

Under the 2008 Tax Act, IRC Sec. 2801 imposes a "succession tax" at the highest applicable estate or gift tax rates (in 2013, 40% tax rate) on the receipt by a U.S. person of a "covered gift or bequest" (i.e. a direct or indirect gift from a covered expatriate within the meaning of IRC Sec. 877A, effective on or after June 17, 2009.) This tax is assessed on, and intended to be paid by, the recipient of a covered gift or bequest (reduced by any foreign gift or estate tax paid).

The IRC Sec. 2801 succession tax does not apply to:

(1) IRC Sec. 2503(b) annual exclusion gifts (2013: $14,000 per donee)

(2) Gifts/Bequests entitled to a marital or charitable deduction;
(3) Gifts to a U.S. citizen spouse;

(4) Gifts to an alien spouse either up to $139,000 per year (2012), See: IRC Sec. 2503(b) and 2523(i), or bequests to an alien spouse left to a qualified domestic trust (IRC Sec. 2056(d), and 2056A;

(5)A taxable gift shown on a timely filed gift tax return or to property included in the estate of a covered expatriate that is shown on a timely filed estate tax return;

(6) Gifts and bequests made by a covered expatriate, during any period following expatriation, when the expatriate is again subject to tax as a citizen or resident of the U.S.;

IRC Sec. 2801 has special tax rules for trusts:

(1) On transfer to a domestic trust, the succession tax will be assessed on and paid by the trust;

(2) For a covered gift or bequest made to a foreign trust, the succession tax will apply to the receipt by a U.S. person of a distribution, whether of income or capital, attributable to a transfer from a covered expatriate.

(3) In calculating his income tax liability, on the receipt of a taxable distribution from a foreign trust, attributable to a covered gift or bequest, a U.S. recipient will be entitled to deduct under IRC Sec. 164, the amount of tax imposed under IRC Sec. 2801 that is attributable to gross income of the recipient but not to the capital portion of the distribution.

<u>1996 Act</u>

Under the 1996 Act, the 1966 alternative tax regime was expanded:

(1) “Covered expatriates” were enlarged to include “long-term resident aliens” defined as “lawful permanent residents” (i.e. “green card holders”) resident for tax purposes in 8 of the prior 15 taxable years (1996 Tax

Act, new IRS Sec. 877(e).

(2) Expatriation was considered to have occurred at the date prescribed for citizens under nationality law (i.e. as of the date of an expatriating act). Such individuals remained subject to IRC Sec. 877 for ten years following the furnishing to U.S. State Department of Statement confirming their loss of citizenship.

(3) Expatriation was considered to have occurred at the date presented for long-term residents under the tax residence rules. IRC Sec. 877(e) refers to IRC Sec. 7701(b)(6) for purposes of determining when an individual ceases to be a lawful permanent resident. An individual granted lawful permanent residency status will remain a tax resident until such status has been revoked or administratively or judicially determined to have been abandoned. Treas. Reg. Sec. 301.7701(b)-1(b), states that abandonment will be considered to occur as of the date an individual provides written notice of such action to the U.S. Citizen and Immigration Services ("USCIS"), an agency of the Dept. of Homeland Security, the successor to the Immigration and Naturalization Service ("INS"), or a consular officer, or the INS issues an order of revocation or abandonment. In the latter case, it is the date of issuance that marks cessation of residence and not the prior effective date of such an order.

<u>The 1996 Act introduced the "presumptive tax avoidance purpose</u>."

A tax avoidance notice was presumed if an individual's net average income tax liability in the 5 years preceding expatriation was $100,000 or more ("income tax liability test") or if his net worth exceeded $500,000 ("net worth test"). This test was for 1996-2004. For 2004, the "2004 Tax Act" modified the expectation rules to increase these amounts to $124,000 (indexed annually beginning in

2005) and $2m (not indexed), respectively. The "2008 Tax Act" further modified these rules, creating a "mark-to-market" tax on "gains" in excess of (in 2012): $651,000, defining a "covered expatriate" with either an average net income tax liability for the 5 years preceding expatriation, for persons expatriating in 2012 exceeds $151,000, or net worth of $2m (or more).

Exceptions were available for certain categories of individuals if they obtained a ruling from the IRS that tax avoidance was not a principal purpose of their expatriation (1996 Act, adding IRC Sec. 877(c)(2) which sets out the categories of expatriating citizens who could apply for a ruling. See: IRS Notice 97-19, 1997-1 C.B. 394 (requirements of ruling procedure) and IRS Notice 98-34, 1998-2 C.B. 29 re: long-term residents.

The 1996 Act significantly enlarged the categories of income considered to be U.S. source income:

(1) Income and gains derived from former controlled foreign corporations ("CFC"), considered controlled by an expatriate within two years prior to expiration were considered to be from U.S. sources if realized within the ten-year post-expatriation period (1996 Act), adding new IRC Sec. 877(d)(1)(c).

(2) Certain gains from otherwise non-taxable exchanges and "other similar occurrences" that resulted in a change of future income sources from U.S. to non-U.S. (1996 Act, adding new IRC Sec. 877 (d)(2).

(3) If during the 10 year period following expatriation a taxpayer contributed property giving rise to U.S. source income to a foreign corporation that had the taxpayer remained a U.S. person, would have been a CFC, then the foreign corporation was disregarded and the expatriate was considered to receive the underlying U.S. source income directly (1996 Act, adding new IRC Sec. 877(d)(4)).

The 1996 Act required the expatriating U.S. taxpayer to provide information reporting:

(1) An information statement to the Dept. of State, including a Statement of net worth, when disclosing an expatriating act (which was forwarded to the IRS).

(2) A departing long term resident was required to provide the same information statement directly to the IRS with their tax return for the year of expatriation (1996 Act, adding new IRC Sec. 6039(g).

(3) An expatriate was required to file a U.S. tax return, including a worldwide income statement, for any of the ten years following expatriation in which he had U.S. sourced income subject to tax (IRS Notice 87-19). The failure to include a worldwide income statement would cause a tax return not to be considered a true and accurate return, leading to a loss of entitlement to deductions and credits under an audit (See Treas. Reg. Sec. 1.874-1).

(4) All expatriating citizens names were to be published by the IRS (after U.S. notification) in the Federal Register. Immigration Authorities were required to furnish the names of all persons whose green cards were revoked or abandoned. (1996 Tax Act, new IRC Sec. 6039 G(d).

2004 Tax Act

Under the American Jobs Creation Act of 2004 ("2004 Act"), the 10-year alternative tax regime on U.S. source income was revised:

(1) It removed the argument that an individual have a principal tax avoidance purpose [for expatriates]

(2) It changed the income tax liability threshhold to greater than $124,000 (indexed annually beginning in 2005) (See

Rev. Proc. 2007-66, 2007-45 IRB 970 (10/18/07).

(3) The net worth test standard was increased to $2m (not indexed) (2004 Act, amending IRC Sec. 877(a)(2).

(4) It added a third test, providing that an expatriate certify that he has fully complied with all U.S. tax requirements for the five years preceding expatriation (2004 Act, adding new IRC Sec.877(a)(2)(C). This requirement is now satisfied by completion and filing of Form 8854. An expatriating individual will be subject to tax under IRC Sec. 877, if he has not complied with his tax obligations, regardless of whether he meets the income tax liability or net worth threshholds.

The 2004 Act added new IRC Sec. 7701(n) provided that an individual will continue to be treated as a U.S. citizen or long-term resident, until he gives both notice of his expatriation to the Department of State or Department of Homeland Security, respectively, and furnishes an information statement required by amended IRC Section 6039(G). The instructions to revised IRS Form 8854 detail the specific acts by which U.S. citizenship and long-term residence may be terminated.

The 2004 Act strengthened the information reporting rules by requiring that an expatriate file an annual information statement for each of the 10 post-expatriation years, regardless of whether the expatriate had any U.S. source taxable income for such year (2004 Act amending IRC Sec. 6035 G(a).

The annual return requirement is satisfied by filing revised Form 8854, which requires that a current balance sheet and world-wide income statement be prepared for each year. Annual information reporting is done on Form 8854, Part III. If an expatriate has taxable U.S. source income and is required to file Form 1040 NR for the year, Form 8854 should be attached to it, or if no U.S. source income, Form 8854 is filed solely.

Exceptions to the provision were limited to certain dual nationals at birth having no “substantial contacts” with the U.S. and minors expatriating before age 18 ½ who were born in the U.S. to non-citizen parents and who have not been in the U.S. more than 30 days in any of the 10 years preceding expiration. “Substantial contacts” with the U.S. will be construed if the individual ever held a U.S. passport, was a U.S. tax resident (IRC Sec. 7701(b), or spent more than 30 days in any of the 10 years preceding expatriation. This exception is only available to individuals who were dual citizens at birth and remain a citizen of the other country.

The 2004 Tax Act added new IRC Section 877(g); under it, an individual otherwise subject to the tax expatriation rules will be subject to income and transfer taxes on his world-wide income and property as a U.S. citizen or resident during any of the post-expatriation years in which he is physically present in the U.S. for more than 30 days.

As stated, for those U.S. taxpayers who expatriated through 2008 (prior to the 2008 Tax Act, i.e. 6/17/08), they are subject to the alternate tax regime (10 years) through 2018.

2008 Tax Act

As stated previously, the 2008 Tax Act repeals the 10 year “alternative tax regime” prospectively, imposing a “mark-to-market tax” (on imputed gains), a “succession tax” (on gifts/bequests paid by the recipient), a 30% withholding tax on: receipt of deferred compensation, the present value of a “specified tax deferred account”, and the taxable portion of a distribution from a non-grantor trust.