TRUST & ESTATE PLANNING (TEP)

Breaking Up Is Hard To Do:

Why Expatriating from the United States Requires Careful Tax Planning

By Sarah B. Sindledecker

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 U.S. tax consequences for him to consider if circumstances change in the future and his U.S. permanent residency is no longer desirable.

Currently, there are two different U.S. tax regimes which operate simultaneously to penalize U.S. taxpayers, and certain U.S. family members of those U.S. taxpayers, for terminating their U.S. residency. On the U.S. income tax side, there is the "exit tax" regime and, from a U.S. transfer tax perspective, there is the "inheritance tax" charge (collectively, these regimes will be referred to as the "U.S. expatriation tax regimes"). The application of these rules turns on whether the U.S. 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 U.S. citizen who relinquished his or her U.S. citizenship at any time or a U.S.

permanent resident who relinquished his or her U.S. 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 U.S. tax filings are not made contemporaneously.

Once a determination has been made that an expatriation has occurred, the expatriate will be subject to the U.S. expatriation tax regimes only if he or she meets one of several tests (in which case, he or she will be considered a "covered expatriate"). The first of these tests is the "tax liability test" which is met if an expatriate has an average net U.S. income tax liability of greater than US$ 161,000 (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 US$ 2,000,000 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 U.S. tax obligations for the five years prior to expatriation under penalty of perjury.

If your client is considered a covered expatriate, then under the exit tax regime, he or she will be subject to a mark-to-market U.S. income tax charge on the vast majority of his or her assets worldwide. A covered expatriate is entitled to exclude only US$ 693,000 (adjusted for inflation) of the gain recognized from the deemed sale. Deferred compensation items, specified tax deferred accounts and interests in nongrantor trusts are subject to a withholding tax regime instead.[1]

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In contrast to the exit tax rules, the U.S. inheritance tax charge is a 40% flat tax applicable to U.S. domiciled individuals who receive gifts or bequests at any time from a covered expatriate which exceed US$ 14,000 (indexed for inflation) during a calendar year. The U.S. 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. While relief is granted in the form of a credit for any gift or estate taxes paid to a foreign country, the credit may be useful only in certain cases. Additionally, 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 U.S. inheritance tax charge.

Because only covered expatriates are penalized for exiting the U.S. tax system, planning to avoid this classification can be beneficial. Of particular interest is the net worth test. For clients who are not U.S. 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.

Based upon IRS guidance, a special rule is provided for purposes of determining an individual's beneficial interest in a trust. 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.

It seems clear that only an individual who is a 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 have nothing to include with respect to the trust in the determination of their net worth. Additionally, assuming there is a discretionary trust from which no distributions have been made, the IRS guidance would seem to preclude the settlor from being allocated any interest in the trust. The trust may need to be located in an asset protection jurisdiction for this result, however.

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

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1) A covered expatriate is subject to a 30% gross basis withholding tax when a taxable amount is paid or distributed to him.

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