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Expatriation

INSIGHT: EXIT TAX: Through the Maze of Expatriation—Part 2

In Part 2 of a two-part article, Ragini Subramanian of Marcum LLP walks through determining the value, type, and location of a taxpayer's assets on the day before expatriation; whether he or she is compliant with all U.S. tax obligations; the date of expatriation; and whether he or she is subject to tax under the U.S. expatriation provisions, and, if so, when that tax is due. The author advises that expatriation is not for the faint of heart.

By Ragini Subramanian

The Treasury Department regularly publishes the names of the individuals who renounce their U.S. citizenship or terminate their long-term U.S. residency (expatriated). (See 82 Federal Register 21877, 36188, 50960 and 5830 in 2017). With well over 1300 names in the first quarter, 1700 names in the second quarter, and almost 1400 names in the third quarter (with some decline in the fourth quarter), 2017 is one of the noteworthy periods in the history of U.S. expatriation that prompts the writing of this article.

One may think that with so many choosing to expatriate, the process must be far from onerous. Not quite! Relinquishing U.S. citizenship or U.S. residency is not easy, as a myriad of complex U.S. tax laws must be complied with before and sometimes even after expatriation. A thoughtful consideration of the kinds, value, and location of assets held before and after expatriation, how will they be taxed in the U.S. as well as in the country that will be home after expatriation, and many other factors need to be reviewed before undertaking expatriation.

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Marcum LLP is a national accounting and advisory services firm with offices in major business markets throughout the U.S., as well as Grand Cayman, China, and Ireland.

This article reviews pre- and post-compliance requirements under the U.S. tax laws for individuals who are thinking about expatriating, that is giving up their U.S. citizenship or long-term U.S. residency. It also touches upon planning and other considerations, before and after actual expatriation, as they relate to the U.S. tax laws.

Part 1 of this article discussed in Sections I, II, and III factors to consider when contemplating expatriation, including whether you are a U.S. citizen or a U.S. resident when you expatriate, and whether you become a ''covered expatriate'' or a ''non-covered expatriate'' upon the date of expatriation and why it matters. Part 2 covers the following:

IV. What is the value, type, and location of the assets owned by you on the day before expatriation?

V. Are you compliant with all U.S. tax obligations?

VI. What is your date of expatriation?

VII. Are you subject to tax under the U.S. expatriation provisions and when is this tax payable?

VIII. What needs to be done before expatriating?

IV. What is the value, type, and location of the assets owned by you on the day before expatriation?

For an expatriating individual, knowing the value of an asset is important for some of the following illustrative reasons.

1. If the combined value of all assets owned by an expatriate on the day before expatriation is more than $2

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million (''net worth'' test) the individual is a ''covered'' expatriate. A ''covered'' expatriate is subject to the mark-to-market or alternative tax regime, whereas a ''non-covered'' expatriate is not. Knowing the ''covered'' or ''non-covered'' status is essential to planning the exit tax strategies (e.g., sell the asset or keep the asset, defer tax, or pay tax at expatriation).

2. Certain assets in the hands of a covered expatriate are subject to the mark-to-market tax regime. Built in gain if any after applying the exclusion amount is taxed in the year of expatriation. The asset value is important to determine the gain or loss and thereby the tax liability as of the date of expatriation and to decide whether to elect or not to elect to defer tax.

3. A deferred compensation item in the hands of a ''covered'' expatriate is subject to the alternative tax regime, and the timing of taxation of such an asset depends on an election to treat this as an eligible or an ineligible deferred compensation item. Knowing the value of this asset is important to plan this timing of taxation.

(This article does not discuss the rules related to valuation of assets for the purposes of ''net worth'' test or to determine gain under the mark-to-market tax regime. For these valuations rules please refer to Notice 97-19 and Notice 2009-85.)

It is noteworthy that what is considered owned for purposes of ''net worth'' test is not the same as what is considered owned to determine gain under the mark-to-market tax regime. The former is under Notice 97-19, Section II, while the latter is under Notice 2009-85. Notice 97-19 applies the gift tax rules for ''net worth'' test, and Notice 2009-85 applies the estate tax rules. Can this lead to mismatch between the value (and/or what is considered owned) that is subject to ''net worth'' test and the value (and/or what is considered owned) that is used to determine tax liability under the mark-to-market tax regime? Possibly. Until the regulations are finalized this discrepancy may cause compliance headaches for some ultra-high net worth expatriates with assets that are subject to the mark-to-market tax regime.

Generally, the valuation mismatch may not be an issue for the assets that are subject to an alternative tax regime. Generally, the taxable amount is tied to the taxable payment from the asset, or the present value of the asset, or the taxable distribution from the asset. In most instances the trustee of the deferred compensation plan, the specified tax deferred account, or the trustee of the non-grantor trust is able to provide this valuation.

For an expatriating individual, knowing the type of asset is important for reasons similar to those for knowing the value of the asset.

Some assets in the hands of an expatriating individual are subject to the mark-to-market tax regime and some to the alternative tax regime. Knowing which of the assets are subject to the mark-to-market and which are subject to the alternative tax regime is important for pre-expatriation tax planning and for post-expatriation compliance planning. For example:

a. Some assets subject to an alternative tax regime may require Form 8854 annually even after expatriation, and a Form W-8CE may have to be filed for others.

b. One would group all built in gain assets that are subject to the mark-to-market regime to apply the exclusion amount and calculate the taxable gain. The assets subject to an alternative tax regime are kept out of this calculation.

c. The owner of the grantor trust may cause himself to become an owner of a foreign trust upon expatriation, or a ''covered'' expatriate's expatriation may cause him to cease to be treated as the owner of the trust. The trust may in that case be required to recognize gain on appreciated property under other provisions of the tax code (*See* Section 684 in this regard), and in that case the gain cannot be reduced by the exclusion amount of Section 877A(a)(3).

Knowing the location of the asset is important for some of the following illustrative reasons:

1. The proceeds from the sale of the U.S. real property interest by a non-resident alien is subject to 15 percent withholding under the Foreign Investment in Real Property Tax Act (FIRPTA) regulations. Section 897. If the expatriating individual owns a U.S. real property interest, it may be worthwhile to review the tax implications of sale of such property before or after expatriation.

2. A taxpayer's principal residence may no longer benefit from the principal residence exclusion rules if she does not live in that residence for at least two years (while continuing to own it) out of the five years before the date of the sale.

A lot to think about here. The above is just a flavor of why one needs to know the value, the type, and the location of the assets. Knowing this is important to be able to analyze and possibly mitigate tax burden as well as the compliance burden.

V. Are you compliant with all U.S. tax obligations?

The tax code Sections 877A(g)(1)(A) and 877(a)(2)(C) require an expatriating individual, to certify under penalty of perjury that she has met the requirements of, or to submit evidence of compliance with the tax code for the five tax years preceding the tax year of expatriation. Failure to certify or to submit evidence makes the expatriating individual a ''covered'' expatriate as discussed above.

What does it mean to sign this certification or submit evidence? Simply put, the expatriating individual should be compliant with all the tax return filings necessary including personal, corporate, partnership, limited liability company, trust, estate, and any other tax returns—such as payroll, employment tax, gift tax—that may need to be filed. In addition, the individual must also be compliant with foreign information reporting forms such as Form 8938, 114, 5471, 5472, 3520, 3520-A, 926, 8621, 8865, 8858, etc. If the non-compliance relates to foreign reporting, the penalties and consequences can be far more serious. Compliance with tax obligations would also mean that the taxpayer has paid all applicable taxes, penalties, and interest, if any, payable by the taxpayer. This includes taxes payable by the expatriating individual under the expatriation provisions unless an election to defer these taxes is properly made by the taxpayer (see *VII. Are you subject to tax under the U.S. expatriation provisions and when is this tax payable?* later in this article).

What happens if the taxpayer is not compliant? If one is not compliant but wants to expatriate, one will be well advised to become compliant before filing Form 8854 and either certifying compliance or leaving this item on Form 8854 unchecked. A word of caution how-

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ever, a Form 8854 with the certification box unchecked is a likely candidate for an audit. If one certifies compliance on Form 8854 but is not compliant, one should be prepared for penalties associated with making false statement if audited.

In my view, the ''certification'' test should not be taken lightly. Before signing a certification of compliance, one must seek professional review of tax returns for five years preceding the year of expatriation. Subject to advice from the professional, one should proceed to comply rather than begin the expatriation procedure. Depending on the level of non-compliance, the date of expatriation may be delayed.

VI. What is your date of your expatriation?

The question seems simple, but it is not. One may desire to leave the U.S. as soon as possible, but the issue is how to plan towards a date, and what is the exact date that one is considered to have expatriated? As discussed earlier in this article, the value of the assets and the tax associated with each is determined on a day before expatriation.

Let us first review what, according to the statute, is the expatriation date.

First the U.S. citizens. Section 877A(g)(3) defines the term expatriation date as the date an individual relinquishes U.S. citizenship. Section 877A(g)(4), Notice 2009-85, and instructions to Form 8854 provide that a U.S. citizen will be treated as relinquishing her U.S. citizenship on the earliest of the following four possible dates:

1. The date the individual renounces her U.S. nationality before a diplomatic or consular officer of the U.S. pursuant to paragraph (5) of Section 349(a) of the Immigration and Nationality Act (8 U.S.C. Section 1481(a)(5)). This renunciation must be subsequently approved by the issuance to the individual of a certificate of loss of nationality by the U.S. State Department.

2. The date the individual furnishes to the State Department a signed statement of voluntary relinquishment of U.S. nationality confirming the performance of an act of expatriation specified in paragraph (1), (2), (3), or (4) of Section 349(a) of the Immigration and Nationality Act (8 U.S.C. Section 1481(a)(1)-(4)). This voluntary relinquishment must be subsequently approved by the issuance to the individual of a certificate of loss of nationality by the State Department.

3. The date the State Department issues to the individual a certificate of loss of nationality.

4. The date a court of the U.S. cancels a naturalized citizen's certificate of naturalization.

In the case of a long-term resident of the U.S., Section 877A(g)(3)(B), Notice 2009-85, and instructions to Form 8854 provide that the expatriation date is the date on which the individual ceases to be a lawful permanent resident of the U.S. within the meaning of Section 7701(b)(6). An individual ceases to be a lawful permanent resident of the U.S. on the earliest of the following four possible dates:

1. The individual voluntarily abandons his lawful permanent resident status by filing Department of Homeland Security Form I-407 with a U.S. Consular or immigration officer;

2. The individual's status of having been lawfully accorded the privilege of residing permanently in the U.S. as an immigrant in accordance with immigration laws has been revoked or has been administratively or judicially determined to have been abandoned;

3. The date the individual became subject to a final administrative or judicial order for his/her removal from the U.S. under the Immigration and Nationality Act; or

4. A dual status resident of the U.S. and a foreign country with which the U.S. has an income tax treaty:

a. commences to be treated as a resident of a foreign country under the provisions of a tax treaty between the U.S. and the foreign country,

b. does not waive the benefits of the treaty applicable to residents of the foreign country, and

c. notifies the Secretary of the Treasury of such treatment on Forms 8833 and 8854 (*See* Treasury Regulations Section 301-7701(b)-7).

The next question is when does one want this date to be? Of course the choice generally belongs to an individual wanting to expatriate (unless one is forced out of the country for some reason, e.g., administrative or judicial, that we will not discuss here, and this date can be anytime during the year). However, from a planning standpoint one may want to come up with a date that can provide maximum benefit. What do I mean? Let us take some examples.

Example 1: Let's assume that an individual is a ''covered'' expatriate only because she meets the net worth test and because the only asset owned is a vacation home, subject to the mark-to-market tax regime, in Country X (not U.S.), which is worth $2 million with a built-in gain. The decision to hold onto this property or sell it before expatriating will depend on the amount of the built-in gain—more than the exclusion amount or less than the exclusion amount, how much more than the exclusion amount, and if a liquid asset is available to pay the tax. If this review results in a decision that the property should be sold before expatriating, the individual may need to postpone the date of expatriation.

Example 2: Let's assume that upon examination of returns for five years before the potential date of expatriation, the individual is informed by her tax lawyer that she was not compliant because income with respect to a foreign asset was not reflected on the tax returns. The individual may consider postponing her expatriation date until after amended returns are properly filed and she is able to certify compliance.

Example 3: Let's assume that an individual is a covered expatriate and among other assets owns a $3 million home in Florida (not a principal residence). She surrenders her U.S. citizenship while continuing to own this Florida home and expatriates to Country X. She sells this home a year after expatriation at a substantial gain. The sale proceeds upon sale of this home are subject to 15 percent withholding under the FIRPTA rules of Section 897 (assume that no exceptions to 15 percent apply). This individual could have waited one year before actually relinquishing her U.S. citizenship if the only intention was to avoid FIRPTA provisions.

In summary, the expatriation date should be looked at very carefully before approaching the relevant authorities and surrendering one's citizenship or long-term residency in the U.S. The perceived tax burden under the U.S. tax laws should be weighed against burden of U.S. expatriation tax provisions and subsequent U.S.

taxes that may be imposed after expatriation. A careful analysis of the tax regime of the new home country should also be undertaken. A consultation with a tax professional is advisable before finally surrendering U.S. citizenship or long-term U.S. residency.

VII. Are you subject to tax under the U.S. expatriation provisions and when is this tax payable?

Subject to exceptions, any tax under the expatriation provision of Section 877A is payable in the year of expatriation. Any period for acquiring property in non-recognition transaction (e.g., Section 1031 deferred exchange) terminates on the day before the expatriation. Section 877A(h)(1). Any extension of time for payment of tax ceases to apply on the day before the expatriation date and the unpaid portion of such tax is due and payable (Section 877A(h)(1)(B)) on the earlier of the date the tax is due and payable and the due date of the expatriating individual's return for the tax year. Notice 2009-85. If the expatriation of the taxpayer causes a U.S. domestic trust to become a foreign trust, the rules of Section 684 requiring recognition of immediate gain will apply before the mark-to-market regime becomes applicable. Section 877A(h)(3) and Notice 2009-85.

Simply put, a non-covered expatriate must pay any tax due up to the year of his/her expatriation. A covered expatriate on the other hand may elect to defer tax payable under the mark-to-market regime but not under an alternative tax regime. Without going into specifics and generally speaking, the tax on an eligible deferred compensation item is payable by a covered expatriate when taxable payment of such item is made.

Tax deferral by a covered expatriate on assets subject to mark-to-market tax regime: A ''covered'' expatriate may elect to defer tax on the property subject to the mark-to-market regime until the earlier of the due date (without extensions) of the ''covered'' expatriate's income tax return for:

(a) the taxable year in which the asset is disposed of by sale, non-recognition transaction, gift, or other means; or

(b) the taxable year that includes the date of death of the ''covered'' expatriate. However, a ''covered'' expatriate may pay any tax deferred under Section 877A(b), together with accrued interest, at any time (Section 877A(b)(1), (2)).

The election is made on an asset-by-asset basis and once made is irrevocable. Section 877A(b)(6). Thus one can defer tax under the mark-to-market regime with respect to one asset but not with respect to the other. In order to make this election the expatriating individual must comply with certain requirements. These are:

■ Provide an adequate security for the property to ensure payment of the tax. This security can be in the form of a bond that meets the requirements of Section 6325, or another form acceptable to the IRS. The IRS must agree that the security is adequate. Section 877A(b)(4)(A) and (B). This can be in the form of a duly executed deferral agreement acceptable by the IRS. A sample of this agreement can be found at Appendix A to Notice 2009-85.

■ Make an irrevocable waiver of any right under any treaty of the U.S. that would preclude assessment or collection of any tax imposed by reason of the expatriation provisions. Section 877A(b)(5).

■ Appoint a U.S. agent to act as the ''covered'' expatriate's limited agent for purposes of accepting communication related to a tax deferral agreement and other matters related to the ''covered'' expatriate. Notice 2009-85. A sample of document to appoint a U.S. agent can be found at Appendix B to Notice 2009-85.

In summary, depending on the type and total value of assets held at expatriation, no tax deferral may be available. A decision to defer or not to defer tax on an asset subject to the mark-to-market tax regime must be taken with great care as the documentation requirement for this is quite involved. If the only reason to expatriate is to get away from the U.S. tax system, seeking tax deferral may defeat the purpose!

VIII. What needs to be done before expatriating?

A few obvious things to think about before expatriating include a thoughtful consideration of the items discussed above, elections to be made, the potential date of expatriation, and post expatriation compliance requirements. The next step would be to surrender U.S. citizenship or long-term U.S. residency as discussed in *VI. What is your date of expatriation*?

File a Form W-8CE with necessary elections with the trustee of the asset that is subject to an alternative tax regime. While one may not need to file this before expatriation, note that the trustee can provide a very clear picture of the taxable value of the property that is reported on the tax return.

The final step would be to file a tax return in the U.S. for the year of expatriation. Unless the expatriation occurs on January 1, the expatriating individual will file a dual status tax return for the year of expatriation. This means that a Form 1040 will be filed for part of the year the taxpayer is the resident or citizen of the U.S. and a Form 1040NR after the expatriation date. On Form 1040, worldwide income on the day before the expatriation is reported. On Form 1040NR only the income effectively connected with the U.S. or U.S. source fixed, determinable, annual, or periodic (FDAP) income (e.g., dividend, interest, rent, etc.) is reported. Also, file Form 8854 along with the tax return filed for the year of expatriation.

Finally, the decision to expatriate is not for the faint of the heart. One must fully review the tax impact of expatriation in the U.S. and in the new home country based on the value, type, and location of assets held by the individual. Seeking professional help would be the first step in getting through the myriad of issues that this article merely touches upon.

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