

# Expatriation Tax

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## Summary

“Leaving so soon, my little pretty? Why my little party’s just beginning.” So says the Wicked Witch of the West to Dorothy. Apparently the little girl from Kansas isn’t the only one in a hurry to escape – US taxpayers by the thousands are abandoning their citizenship in hopes of fleeing the evil clutches of the IRS. But the party may indeed just be starting with the imposition of the expat tax, the government’s last-ditch attempt to grab its “fair” share. This course will help practitioners determine who is subject to the exit tax, how it is computed, and when it must be reported.

*The information contained herein is for educational use only and should not be construed as tax, financial, or legal advice. Each individual’s situation is unique and may require specialized treatment. It is, therefore, imperative that you consult with tax and legal professionals prior to implementation of any strategies discussed.*

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## I. Introduction

Writer T.S. Eliot of St. Louis, Missouri moved to the United Kingdom and relinquished his US citizenship in 1927; entertainer Josephine Baker gave up her citizenship in 1937 disgusted by the overt racism against blacks she experienced; German-born artist Max Ernst immigrated in 1941 but turned in his American passport to become a French citizen in 1958, the same year that Earl Tupper (Tupperware) renounced; film director John Huston emigrated to Ireland in protest over the activities of the House Committee on Un-American Activities and renounced US citizenship in 1964; actor Yul Brynner relinquished in 1965; opera singer Maria Callas renounced in 1966; Christina Onassis renounced her citizenship and donated the American portion of her holdings in her father's company to the American Hospital of Paris in 1975; Queen Noor forfeited her US citizenship and became a Jordanian citizen upon her marriage to King Hussein in 1978; financier John Templeton left Wall Street behind in 1986; martial artist Jet Li moved to Singapore and renounced his US citizenship in 2009; born in Brazil but naturalized in 1996, Eduardo Saverin of Facebook fame renounced his US citizenship in 2011; Tina Turner, Rock and Roll Hall of Famer, relinquished her US citizenship and became a Swiss citizen in 2013.

Elizabeth Taylor renounced her citizenship not just once but twice; first in 1965 and again a year later. Famous for her many marriages, Taylor's first divorce from Richard Burton in 1974 was followed by remarriage in the next year and a second divorce in 1976; similarly, Taylor became a US citizen a second time in 1977 – one of only a handful of ex-citizens granted the opportunity to repatriate. In fact Roger Ver, known as the "Bitcoin Jesus", gave up his US citizenship in 2014. Merely hoping to visit – not repatriate into – the US, Ver has been denied permission by US authorities to attend a conference in Miami!

The list of US citizens who have chosen to expatriate is long but hardly exclusive. Just shy of 3,000 individuals renounced their US citizenship or terminated long-term US residency in 2013, a 221% increase over the 932 who left in 2012, foretelling of more in 2014 and beyond.<sup>1</sup> Reasons vary; including everything from a desire to return to family roots, marry a foreign national, accept a diplomatic appointment, pursue a political career, represent an athletic team at the Olympics, avoid deportation from a foreign country, evade the draft, or because dual citizenship was not an available option. Some expatriates have publically stated their desire "to be free from the silly US laws" [Vince Cate, encryption expert, 1994]<sup>2</sup>, to protest America's participation in the Korean War [Stefan Heym, WWII refugee from Germany, 1953]<sup>3</sup>, to obtain release from detention as an enemy combatant [Yaser Hamdi, American detained since by the

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<sup>1</sup> *Forbes* reports that 2,353 individuals have renounced US citizenship through the third quarter of 2014. A survey of US citizens living abroad has found that an additional 5.5 million individuals (73% of those questioned) are also considering renouncing. "Americans Renounce Citizenship in New Record Numbers", October 30, 2014 [available at <http://www.forbes.com/sites/robertwood/2014/10/30/americans-renounce-citizenship-in-record-numbers-why-you-should-care/>, last accessed January 31, 2015].

<sup>2</sup> Wayner, "Encryption Expert Says US Laws Led to Renouncing of Citizenship", *Technology CyberTimes*, September 6, 1998 [available at <http://partners.nytimes.com/library/tech/98/09/cyber/articles/06encrypt.html>, last accessed January 31, 2015].

<sup>3</sup> Binder, "Stefan Heym, Marxist-Leninist Novelist, Dies at 88 on Lecture Tour in Israel", *The New York Times*, December 18, 2001 [available at <http://www.nytimes.com/2001/12/18/arts/stefan-heyman-marxist-leninist-novelist-dies-at-88-on-lecture-tour-in-israel.html?pagewanted=all>, last accessed January 31, 2015].

US-allied Northern Alliance in Afghanistan, 2004]<sup>4</sup>, or to become a citizen of the world [Garry Davis, activist, 1948].<sup>5</sup>

Many have not given a reason; they don't have to. But those of us left behind may collectively speculate. *Forbes* reports that some Americans have left because they “say that the US tax and disclosure laws are downright oppressive.”<sup>6</sup> US taxpayers living abroad are particularly hard-hit as they must file US tax returns on worldwide income, which may already be taxed by their resident countries. While taxpayers may avail themselves of treaty benefits or claim the Foreign Earned Income Exclusion and/or the Foreign Tax Credit, the effect of double taxation is not always fully mitigated; most certainly, the reporting requirements are not eliminated.

Additionally, foreign account reporting has become ever more onerous, along with incredibly steep penalties for failure to comply. And, as financial institutions throughout the world discover that *they* must comply with the complex and burdensome rules of the Foreign Account Tax Compliance Act (FATCA), Americans abroad often become personae non gratae for even the simplest of banking activities. Sometimes it's just easier to say goodbye!

## II. Expatriation Tax<sup>7</sup>

But leaving is not easy and does not come cheaply. Knowing that it would likely be difficult if not impossible to collect tax from afar, Congress has enacted laws to ensure that US citizens and residents pay their fair share long before they escape the collection clutches of the US Treasury. The Expatriation Tax is an asset-based tax designed to discourage US citizens from taking assets and their attendant income streams out of the federal system of taxation.

The tax is onerous, just as it is intended to be. But, it seems, it is not yet onerous enough as we hear news story after news story of US taxpayers packing it up and moving out with all of their wealth in tow. *The Huffington Post*, for example, reports that “Facebook co-founder Eduardo Saverin renounced his American citizenship to move to Singapore [and that] super-rich Democratic donor Denise Rich also gave up her passport to permanently move to Europe” in an attempt to avoid US taxation.<sup>8</sup> Apparently for some, it is cheaper to leave and pay the expatriation tax than it is to stay and pay the income tax.

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<sup>4</sup> “Hamdi voices innocence, joy about reunion”, CNN.com, October 14, 2004 [available at [http://www.cnn.com/2004/WORLD/meast/10/14/hamdi/index.html?\\_s=PM:WORLD](http://www.cnn.com/2004/WORLD/meast/10/14/hamdi/index.html?_s=PM:WORLD), last accessed January 31, 2015].

<sup>5</sup> Fox, “Garry Davis, Man of No Nation Who Saw One World of No War, Dies at 91”, *The New York Times*, July 28, 2013 [available at [http://www.nytimes.com/2013/07/29/us/garry-davis-man-of-no-nation-dies-at-91.html?pagewanted=all&\\_r=0](http://www.nytimes.com/2013/07/29/us/garry-davis-man-of-no-nation-dies-at-91.html?pagewanted=all&_r=0), last accessed January 31, 2015].

<sup>6</sup> Wood, “Americans Renouncing Citizenship up 221%, All Aboard the FACTA Express”, *Forbes*, February 6, 2014 [available at <http://www.forbes.com/sites/robertwood/2014/02/06/americans-renouncing-citizenship-up-221-all-aboard-the-fatca-express/>, last accessed February 4, 2015].

<sup>7</sup> IRC §§ 877 and 877A (enacted with the passage of The Heroes Assistance and Relief Tax Act of 2008).

<sup>8</sup> *American Expat Taxpayers Would Rather Ditch Citizenship than Face New IRS Rules*, Huff Post, April 27, 2013 [available at [http://www.huffingtonpost.com/2012/11/09/american-expat-taxpayers-would-rather-ditch-citizenship-than-face-new-irs-rules\\_n\\_2094559.html](http://www.huffingtonpost.com/2012/11/09/american-expat-taxpayers-would-rather-ditch-citizenship-than-face-new-irs-rules_n_2094559.html), last accessed April 27, 2013].

## A. History

After a few false starts, the 16<sup>th</sup> Amendment to the US Constitution was enacted in 1913, creating an income tax regime that was citizenship- rather than residence-based and that applied to “every citizen of the United States, whether residing at home or abroad.”<sup>9</sup> Within a year, US citizens living in London began to renounce their citizenships to escape double taxation! Nevertheless, the Supreme Court upheld the constitutionality of the taxation of Americans on their foreign-earned income.

*“...the basis of the power to tax was not and cannot be made dependent upon the situs of the property in all cases, if being in or out of the United States, and was not and cannot be made dependent upon the domicile of the citizen, that being in or out of the United States, but upon his relation as citizen to the United States and the relation of the latter to him as citizen.”<sup>10</sup>*

Although Congress has never since made any attempt to rescind the taxation of US citizens abroad, various provisions have been enacted to mitigate the deleterious effects upon taxpayers subject to multiple taxing authorities. The Foreign Tax Credit introduced in 1918 allowed Americans to claim a credit for taxes paid to a foreign government<sup>11</sup> and in 1926, the Foreign Earned Income Exclusion allowed taxpayers to shield an unlimited amount of foreign earnings (but not investment income) from US taxation if they lived abroad for at least six months in any calendar year.<sup>12</sup> The exclusion was later limited to \$20,000 per year, rising to \$35,000 annually for those still living abroad after three years.<sup>13</sup> The limitation was raised in fits and starts during the next several decades and finally adjusted for inflation beginning in 2005.<sup>14</sup> It is currently set to \$100,800 in 2015.

Alas, neither the Foreign Tax Credit nor the Foreign Earned Income Exclusion serve to make the taxation of US citizens abroad entirely fair or even comparable to that of US residents. Non-resident citizens, for example may not claim deductions for contributions made to foreign charities and cannot make tax-free transfers of their estates to non-citizen spouses.

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<sup>9</sup> The first income tax enacted by Congress in 1861 specifically excluded overseas income, but legislation soon followed that taxed non-residents on non-US income (1864-72). Congress tried again to tax foreign income in 1894-95. *Background and history of tax on US expatriation* [available at <http://www.taxesforexpats.com/expat-tax-advice/Background-and-History-of-Tax-On-Expatriation.html>, last accessed February 4, 2014].

<sup>10</sup> *Cook v. Tait*, 265 US 47(1924).

<sup>11</sup> Revenue Act of 1918.

<sup>12</sup> Revenue Act of 1926, Chapter 27, Section 213(b)(14), 44 Stat. 9 (1926).

<sup>13</sup> Revenue Act of 1962, PL 87-834, Chapter 11, 76 Stat. 960 (196).

<sup>14</sup> Tax Increase Prevention and Reconciliation Act of 2005 (P.L. 109-222).

Whether in protest or out of economic necessity, ever more US citizens began to renounce their citizenship. To stem the flow or at least introduce a deterrent to expatriation, Congress enacted a ten-year tax on US-source income of individuals whose motive for expatriation was tax avoidance. The 1966 law,<sup>15</sup> however, was unenforceable since the IRS was not informed of expatriations and was unable to objectively determine whether the taxpayer's departure was motivated by "tax avoidance." Thirty years later, the law was revised to *presume* that high net worth individuals chose to expatriate for no other reason than to avoid the payment of US taxes.<sup>16</sup> With yet another revision in 2004, this presumption became a definition which held that all departing taxpayers who met legislated income or net worth thresholds were incontrovertibly leaving for tax avoidance reasons only.

## B. The "Exit" Tax



In 2008, the law changed yet again when Congress unanimously approved a new tax designed to raise revenues to fund increased veterans' benefits authorized by the Heroes Earnings Assistance and Relief Tax Act (HEART). Dubbed the "Billionaires' Amendment" by Senator Edward Kennedy (D-Mass.), this tax was designed to nab the super-rich but in reality applies to all "covered expatriates", defined as those who leave the US and meet one of three tests.

### Tests for "covered" expatriates<sup>17</sup>

1. Income Tax Test – average annual US income tax liability during most recent 5 years prior to expatriation must be over \$139,000<sup>18</sup>
2. Net Worth Test – must be in excess of \$2 million on the date of expatriation.
3. Compliance Test – the expatriate must certify that he has met all US tax obligations for the five years before expatriation.

NOTE: The reason for leaving no longer matters. As per IRC §877A,<sup>19</sup> the tax will apply to all covered expatriates, so classified based on one of these three objective tests.

### Exempt Individuals

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<sup>15</sup> The Foreign Investors Tax Act of 1966.

<sup>16</sup> Health Insurance Portability and Accountability Act of 1996.

<sup>17</sup> Different rules apply depending upon the date of expatriation – details are available at <http://www.irs.gov/Individuals/International-Taxpayers/Expatriation-Tax> [last accessed February 5, 2015].

<sup>18</sup> This amount has since been indexed for inflation – the applicable amounts for each year are: \$145,000 (2009 - 10), \$147,000 (2011), \$151,000 (2012), \$155,000 (2013), \$157,000 (2014) and \$160,000 (2015).

<sup>19</sup> Effective June 18, 2008.

Individuals who have held dual citizenship from birth and have not lived in the US more than 10 of the most recent 15 years are exempt from the expat tax requirements; as are persons younger than 18½ who have not lived in the US more than 10 years.<sup>20</sup>

### C. How to Expatriate

Leaving or exiting the US is of course a prerequisite to the imposition of the tax, so it becomes critical to determine whether in fact a US citizen or resident has jumped through the requisite hoops. Merely handing over your passport to customs agent at the airport will hardly satisfy the government's criteria. Long gone and "free", the traveler will soon discover the near-limitless reach and tenacity with which the IRS will undertake pursuit.

Expatriation is a personal right that cannot be exercised on behalf of another (e.g., a parent renouncing the citizenship of a minor child).<sup>21</sup> The burden – by a preponderance of the evidence – is upon the expatriate to prove that all the proper steps have been taken.

While it is possible to relinquish US citizenship by serving in the armed forces of an enemy state, accepting policy-level employment with a foreign government, or being convicted of treason, the quickest and most unequivocal way to give up US citizenship is by swearing an oath of renunciation before a diplomatic or consular officer abroad.<sup>22</sup>

NOTE: The expatriating act must occur abroad (except during war-time.)

An individual seeking to renounce his citizenship must do so voluntarily. He will be required to complete a questionnaire,<sup>23</sup> have an interview with a US diplomatic officer abroad, and must receive official approval by the Department of State.<sup>24</sup> The fee charged by consular offices for renunciation services have recently increased from \$450 to \$2,350 (!) effective September 12, 2014.<sup>25</sup>

### US Citizens

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<sup>20</sup> IRC § 877A(g)(1)(B).

<sup>21</sup> The US Department of State presumes that a minor under the age of 16 is insufficiently mature and cannot have the knowing intent to renounce citizenship; the minor will only be allowed to renounce pending approval by a consular officer who has conducted an extensive interview with the child outside of his parents' presence. If the minor is permitted to renounce, he will automatically be granted a 6-month window following his 18<sup>th</sup> birthday to reclaim his citizenship [8 USC §1483(b)].

<sup>22</sup> 8 USC § 1481(a).

<sup>23</sup> Form DS-4079 Request for Determining Possible Loss of US Citizenship.

<sup>24</sup> Form DS-4083 Certificate of Loss of Nationality of the United States.

<sup>25</sup> Fee schedule posted by the US Department of State at <http://www.state.gov/r/pa/prs/ps/2014/231128.htm> [last accessed February 5, 2014].

A citizen will be treated as relinquishing US citizenship on the earliest of four possible dates:

- the date the individual renounces US nationality before a US diplomatic or consular officer,<sup>26</sup> provided the renunciation is approved and a certificate of loss of nationality is subsequently issued by the US Department of State, or
- the date the individual furnishes to the US Department of State a signed statement of voluntary relinquishment of US nationality and a certificate of loss of nationality is subsequently issued, or
- the date the US Department of State issues to the individual a certificate of loss of nationality, or
- the date a US court cancels a naturalized citizen's certificate of naturalization.<sup>27</sup>

### US Residents

A long-term resident ceases to be a lawful permanent resident (LPR) if:

- the individual's immigration and residency status has been revoked or has been administratively or judicially determined to have been abandoned, or
- the individual is treated as a resident of a foreign country under the provisions of a tax treaty between the US and the foreign country, does not waive the benefits of the applicable treaty, and notifies the IRS of such treatment on **Forms 8833 Treaty-Based Return Position Disclosure** and **8854 Initial and Annual Expatriation Statement**, or<sup>28</sup>
- by formally abandoning his status.

NOTE: A US lawful permanent resident (Green Card holder) is subject to expatriation rules only if he has become a "long-term resident", defined as an individual – other than a US citizen – who has been a lawful permanent resident of the US in at least 8 of the last 15 tax years ending with the year that residency ends.<sup>29</sup> Therefore, an LPR who is not a long-term resident cannot, by definition expatriate and cannot be held liable for the exit tax or any future tax on covered gifts and bequests.

A long-term resident may abandon his status voluntarily, willingly and affirmatively by submitting **Form I-407 Abandonment of Lawful Permanent Resident Status** to a consular officer. A long-term resident may also forfeit his residency status inadvertently if (1) tie-breaker rules determine that he is a resident of a treaty country and not the US, (2) no waiver of the applicable treaty is made, and (3) the LPR notifies the Secretary of such treatment under a treaty.

TIP: A taxpayer deemed to be a "dual resident" under a tax treaty and who is a resident of a foreign country, should file **Form 1040NR US Nonresident Alien Income Tax Return** and attach **Form 8833**.

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<sup>26</sup> Form DS-4080 Oath/Affirmation of Renunciation of Nationality of United States.

<sup>27</sup> IRC § 877A(g)(4).

<sup>28</sup> IRC § 877(e)(2).

<sup>29</sup> IRC §877A(g)(2).



### III. Computing the Tax

The exit tax is an asset-based tax that is assessed against US citizens who have renounced their citizenship and long-term residents who have ended their residency status. Different rules and rate structures apply depending on the date of expatriation. This manual will examine the rules in effect for expatriations after June 16, 2008.

#### A. Basis for the Tax

The exit tax is a mark-to-market tax that is assessed on all of the expatriate's property which is deemed to have been sold on the day before the expatriation. The resulting phantom gains and losses<sup>30</sup> from the deemed sales are reportable in the taxable year in which they are deemed to have occurred.



Property includes worldwide assets as well as future gifts and bequests that the expatriate intends to make. Believe it or not, this is a *lifetime* requirement!

NOTE: Specified tax-deferred accounts – including individual retirement plans, tuition programs, Coverdell education savings accounts, health savings accounts and Archer MSAs – are included at the value on the day before expatriation.

#### Exempt Assets

Assets which are not counted as part of the taxable basis include:

- Eligible deferred compensation plans
- Certain retirement accounts, including simplified employee pension plans (SEPs)
- Non-grantor trusts<sup>31</sup>

While not subject to the deemed sale regime of the exit tax, these assets are instead subject to an automatic 30% withholding at the time payments are made to a beneficiary. To qualify for this treatment: (1) the payer must be a US entity or a foreign entity that has agreed to US withholdings, (2) the recipient must notify the payer of his ex-citizen status using **Form W-8CE Notice of Expatriation and Waiver of Treaty Benefits**, and (3) the recipient agrees to permanently waive all claims to a reduction of withholdings under any tax treaty.

#### Example

Taxpayer relinquishes his citizenship on December 17, 2009 and becomes a covered expatriate. On December 16, 2009, Taxpayer was an employee of Corporation Z, a US corporation, for which Taxpayer performed all services in the US. On the day before his expatriation, Taxpayer had restricted stock units which had been granted in 2008 that entitled him to 100 shares of the

<sup>30</sup> The wash sale loss provisions of IRC § 1091 do not apply.

<sup>31</sup> Non-grantor trust means the portion of any trust, whether domestic or foreign, of which the covered expatriate is not considered the owner as of the day before the expatriation date [IRC § 877A(f)(3)].

company's common stock if he continued to provide substantial services to the company until December 16, 2013. Although Taxpayer's restricted stock units do not provide for a deferral of compensation for purposes of IRC § 409A since he *no longer works* for the company, the units are deferred compensation items within the meaning of IRC § 877A(d)(4)(D). The units will be treated as substantially vested on the day before expatriation and their fair market value will be includible in the computation of the exit tax.

If, however, Taxpayer *continues to perform services* for Corporation Z, timely notifies the company of his status as a covered expatriate and irrevocably waives any right to claim any withholding reduction under any treaty with the US, the restricted stock units will be deemed "eligible deferred compensation". Taxpayer, therefore, will have no income inclusion on the date of expatriation but will instead be subject to 30% withholding tax on the pro-rated portion of payout that is allocable to his earnings while in the US. If, for example, Taxpayer can reasonably determine that 80% of the value of the stock that is eventually transferred to him December 16, 2013 is attributable to services performed outside the US when he was no longer a US citizen or resident, then only 20% of the distribution will be includible in gross income and subject to withholding.

NOTE: Assets subject to withholdings are not eligible for the exclusion amount.

## B. Exclusion Amount

The tax basis is reduced (but not below zero) by an exemption amount that is adjusted annually for inflation.<sup>32</sup> The exclusion amount is currently set at \$690,000 [in 2015].<sup>33</sup>

Each individual is eligible for only one lifetime exclusion<sup>34</sup> amount which must be allocated amongst all of the built-in gain properties subject to the mark-to-market regime by multiplying the exclusion amount by the ratio of each asset's built-in gain divided by the total built-in gain of all assets. The exclusion amount allocated to each gain asset may not exceed the amount of that asset's built-in gain.

### Example

A covered expatriate relinquished his citizenship on November 1, 2009. On October 31, 2009, owned the following assets with a total built-in gain of \$2,000,000:

Asset	FMV (\$) on 10/31/09	Basis (\$) FMV at Purchase	Built-in Gain (Loss) (\$)
X	2,000,000.	200,000.	1,800,000.
Y	1,000,000.	800,000.	200,000.
Z	500,000.	800,000.	(300,000.)

<sup>32</sup> IRC § 877A(a)(3).

<sup>33</sup> Exclusion amounts previously in effect: \$600,000 (2008), \$626,000 (2009), \$627,000 (2010), \$637,000 (2011), \$651,000 (2012), \$668,000 (2013) and \$680,000 (2014).

<sup>34</sup> If a covered expatriate repatriates at a later time, then once more loses his citizenship or ceases to be a lawful permanent resident, the exclusion amount with respect the second expatriation is limited to the unused portion of the first expatriation, as adjusted for inflation.

Step 1:	Determine the portion of the exclusion amount allocable to each gain asset by multiplying the exclusion amount [\$626,000 for 2009] by the ratio of the built-in gain on each gain asset over the total built-in gain on all gain assets.  Asset X: $(1.8 \text{ million} \div 2 \text{ million}) \times 626,000 = \$563,400$ Asset Y: $(200,000 \div 2 \text{ million}) \times 626,000 = \$62,600$  NOTE: The exclusion amount is not allocated to the asset with a built-in loss.
Step 2:	Determine the amount includible in gross income with respect to each gain asset by subtracting the exclusion amount allocated to each asset from the amount of built-in gain deemed realized.  Asset X: $1.8 \text{ million} - 563,400 = \$1,236,600$ Asset Y: $200,000 - 62,600 = \$137,400$
Step 3:	The taxpayer must report all includible amounts in gross income with respect to Assets X and Y, as well as the loss with respect to Asset Z on <b>Form 1040</b> for the portion of the taxable year that includes the day before the expatriation date. <b>Form 1040</b> and all attendant schedules should be attached as supplementary schedules (exhibits) to <b>Form 1040NR</b> for the remainder of that taxable year.

NOTE: Deemed IRC §877 losses and gains are subject to the usual netting rules and limitations [IRC §1211] but are exempt from the wash sale rule [IRC §1091].

Any amount of gains or losses actually realized after the deemed sales on the date of expatriation will be adjusted for gains and losses taxed under the expat tax regime.

<u>Example</u> The taxpayer in the foregoing example now lives abroad and sells Asset X for \$3,000,000 and Asset Z for \$700,000 on October 15, 2013. His taxable gain is computed as follows:  Asset X: $3 \text{ million sales proceeds} - 2 \text{ million adjusted basis} = \$1,000,000$ Asset Z: $700,000 \text{ sales proceeds} - 500,000 = \$200,000$  NOTE: Taxpayer's basis is adjusted to reflect the fair market value of each asset on the day before expatriation without regard to the allocated exclusion amount.
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### In-bound Step-up for Non-resident Aliens

In general, non-residents aliens (NRAs) who own foreign property when they become resident aliens of the US do not get a stepped-up basis when residency begins.

<u>Example</u> NRA bought land in Europe for the equivalent of US \$100,000 in 2002. He becomes a US resident in 2005 when the land was valued at \$150,000 and eventually sells the land in 2013 for \$400,000. He will have a taxable capital gain of \$300,000.
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However, a special exception applies for the purpose of the mark-to-market regime of the exit tax. As per the exception, an NRA who became a US resident but then expatriates must - solely for purposes of determining the tax imposed by reason of section 877A(a) - adjust the basis of all assets (except those used or held for use in connection with the conduct of a trade or business within the US) to the fair market value

on the date that he became a US resident.<sup>35</sup> The taxpayer may make an irrevocable election on a property-by-property basis to be exempt from this rule.<sup>36</sup>

**Example**

In the foregoing example, the NRA who became a US resident, later abandoned his residency and returned to his native country. Unless the taxpayer makes an affirmative election,<sup>37</sup> the basis of the land will be automatically stepped-up to \$150,000; the resulting deemed gain for purposes of the exit tax will be reduced to \$250,000.

NOTE: Property used in connection with a US trade or business is not eligible for the inbound basis step-up.

**C. Gifts and Bequests to US Citizens<sup>38</sup>**

Alas, a former US citizen or long-term resident is subject not only to the *one-time* exit tax, but is also *forever* subject to gift and estate taxes for any gifts or bequests made to US citizen and resident donees and beneficiaries. Gifts and bequests made to non-US citizens are exempt from the gift and estate tax regime.

Gifts and bequests made by a covered expatriate are valued as they would be under the estate tax regime, then reduced by the applicable annual exclusion [\$14,000 in 2015], and taxed at the highest marginal bracket of gift or estate tax in effect during the year of the gift. The resulting tax becomes the liability of the receiving transferee.

NOTE: If the gift were made while the donor was still a US citizen, the donor would remain eligible for the lifetime exclusion; the gift would only be taxable in the event that it exceeded that amount [\$5.43 million in 2015]. Additionally, it would be the donor (not the donee) who becomes liable for the resulting gift tax.

Similarly, a US citizen transferring assets to US beneficiaries at death may use his available lifetime exclusion to reduce or even eliminate the estate tax; whereas, non-citizen decedents may not benefit from this exemption.

**Example**

Decedent A – a US citizen at death – has an estate valued at valued at \$7 million on the date of death in 2015. Presuming the full lifetime exclusion were available and the estate were taxed at the highest marginal rate currently in effect [40% in 2015], the net estate after tax that would pass to beneficiaries would total \$6,372,000.

<sup>35</sup> IRC §877A(h)(2).

<sup>36</sup> The election is made on Form 8854 which must be filed with the covered expatriate's income tax return for the taxable year that includes the day before the expatriation date.

<sup>37</sup> Individual taxpayers may have differing reasons for electing to forego what appears to yield a significant tax benefit; for example, a taxpayer may not wish to incur the expense and inconvenience of obtaining an appraisal to establish valuation on the date of residency.

<sup>38</sup> IRC §2801.

In contrast, Decedent B – a non-US citizen at death – could reduce his taxable estate by only \$14,000 per beneficiary. Presuming that the decedent had two beneficiaries, the net estate after tax that would pass to those beneficiaries would total \$4,211,200, more than \$2 million less than Decedent A's estate!

NOTE: A foreign trust which is funded by a covered expatriate who has named US citizen or resident beneficiaries is subject to these same rules.

**Example**<sup>39</sup>

Married US citizens who have \$3M of cash (as their only assets) when they renounce citizenship will have no mark-to-market tax to pay since there can be no phantom income on cash. However, if the former citizens then grow a successful business while living in their home country, such that all wealth of this business was created as non-US persons outside the US, any future gifts or bequests to US persons would be subject to a 40% tax at current tax rates [in 2015]. For instance if the estate was grown to a value \$10 million and bequeathed to three US citizen children, the children would have to pay \$4 million in taxes [under current rates]; even if none of the children lived in the US!

Blog author impuestospatrick warns that this “forever taint” could live on for multiple generations if trust beneficiaries include children, grandchildren and even great-grandchildren who are US citizens or have dual citizenship with the US.

#### IV. Reporting the Tax

Gain or loss on the deemed sale of each asset – albeit not actually realized – is recognized and reported on the relevant form or schedule of the individual's **Form 1040 US Individual Income Tax Return** for the year that includes the day before the expatriation date.

The gain or loss is reported in the same manner as if the property had actually been sold. For example, gain recognized from the deemed sale of a rental property that has been depreciated is reported on **Form 4797 Sale of Business Property** as if it had been sold. Gain recognized from the deemed sale of personal property (such as stock or a personal residence) is reported on **Form 8949 Sales and Other Dispositions of Capital Assets** as if it had been sold.

A capital gain retains its character as a capital gain (whether short- or long-term); ordinary gain retains its character as ordinary income.<sup>40</sup>

##### A. Payment of the Tax

The exit tax is due 90 days after expatriation but may be deferred on an asset-by-asset basis until the due date (plus extensions) of the expatriate's income tax return for the year in which the asset is actually sold.<sup>41</sup> Taxpayers making an irrevocable election to

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<sup>39</sup> The “Hidden Tax” of Expatriation – Section 2801 and its “Forever Taint”, *Tax Expatriation* blog by impuestospatrick, April 10, 2014 [available at <http://tax-expatriation.com/2014/04/10/the-hidden-tax-of-expatriation-section-2801-and-its-forever-taint/>, last accessed February 6, 2015].

<sup>40</sup> Instructions for Form 8854 (2012), Department of Treasury, Internal Revenue Service.

<sup>41</sup> IRC § 877A(b)(1).

defer payment must fill in Section C of **Form 8854 Initial and Annual Expatriation Statement** and furnish a bond to the Secretary of the Treasury<sup>42</sup> or another satisfactory security (e.g., letters of credit) as prescribed by the Secretary.

If the deferral agreement is accepted by the IRS, the taxpayer may not extend the due date for payment of the deferred tax beyond the earlier of either:

- The due date of the return required for the year that includes the date of death, or
- The date that the posted security is no longer considered adequate by the IRS (unless the taxpayer increases his security within 30 days after notification)<sup>43</sup>

NOTE: Interest on any unpaid liability resulting from the exit tax continues to accrue until the balance due is paid in full.

## **B. Other Requirements**

**Form 8854** must be filed with a US consular office or federal court at the time of expatriation.<sup>44</sup> Until the taxpayer files the form and notifies either the US Departments of State or Homeland Security of his expatriation or termination of long-term residency status, the taxpayer will continue to be treated as a US citizen or resident for tax purposes.<sup>45</sup> Failure to file **Form 8854** is subject to a \$10,000 penalty.

The taxpayer must be able to certify that he has complied with all federal tax filing requirements for the 5 years prior to expatriation.<sup>46</sup> Expatriates should file all tax returns that are due, regardless of whether or not full payment can be made at the time of filing since a payment plan may be arranged for any outstanding tax liability.

### Annual Reporting

Individuals who have expatriated after June 3<sup>rd</sup>, 2004 are required to file **Form 8854** upon expatriation as well as annually thereafter. The form is due on April 15<sup>th</sup> of each subsequent year. Expatriates subject to the tax must also file **Form 1040NR** for each of the next 10 years after expatriation.

## **C. State Tax Rules**

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<sup>42</sup> IRC § 6325(a)(2).

<sup>43</sup> IRS Notice 2009-85 Guidance for Expatriates Under Section 877A.

<sup>44</sup> IRS Instructions for Form 8854 specify how individuals should certify that they have met their federal tax obligations for the 5 preceding taxable years and what constitutes notification to the Department of State or the Department of Homeland Security.

<sup>45</sup> IRC § 7701(n).

<sup>46</sup> Even taxpayers who otherwise do not meet the §§ 877 and 877A filing thresholds must satisfy the 5-year compliance requirement – if they fail to meet this requirement, they will be treated as though they met the §§ 877 and 877A thresholds and will be subject to all expat tax provisions.

It is important to note that only federal rules have been discussed in this manual. Most states do not conform to the federal definition of non-resident and certainly do not care if the taxpayer they seek to tax is a US citizen. For state tax purposes, residency and often domicile are the determinative factors whether the state has jurisdiction to impose its income tax.

A California resident, for instance, is any individual who is either (1) present in the state for a purpose that is not temporary or transitory or (2) is domiciled<sup>47</sup> in California but located outside California for a temporary or transitory purpose. The state applies a facts and circumstances test to establish residency. In the FTB Publication 1031 Guidelines for Determining Resident Status the following factors are listed:

- Amount of time spent in versus out of California
- Location of spouse/RDP, children and principal residence
- State that issued driver's license and where vehicles are registered
- State in which professional licenses and voter's registration are maintained
- Location of bank accounts, real property and investments
- Location of healthcare providers, accountants and attorneys
- Location of social ties, including place of worship, social and country clubs

The Franchise Tax Board warns that this is only a partial list and that all the facts of an individual's particular situation must be evaluated to determine residency status.

NOTE: Other states may have other criteria but in all cases, it should be noted that a taxpayer's status determined under immigration law, federal tax law, or by application of a tax treaty (to which the US government is a signatory) is determined for *federal* purposes only.

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<sup>47</sup> California defines "domicile" as the place where a person voluntarily establishes himself and his family, not merely for a special or limited purpose, but with a present intention of making it his true, fixed, permanent home and principal establishment. It is the place where, whenever absent, he intends to return [available at [https://www.ftb.ca.gov/individuals/fileRtn/Nonresidents\\_PartYear\\_Residents.shtml](https://www.ftb.ca.gov/individuals/fileRtn/Nonresidents_PartYear_Residents.shtml), last accessed February 6, 2014].

APPENDIX A

Form 8854 [pages 1 & 2 of 6]

Form 8854 Initial and Annual Expatriation Statement
OMB No. 1545-0074
2014 Attachment Sequence No. 112
Department of the Treasury Internal Revenue Service
For calendar year 2014 or other tax year beginning , 2014, and ending , 20
Information about Form 8854 and its separate instructions is at www.irs.gov/form8854.
Please print or type.
Name Identifying number (see instructions)

Part I General Information. For all filers.

- 1 Mailing address and telephone number where you can be reached after expatriation
2 Address of principal foreign residence (if different from line 1)
3 Country of tax residence (if different from line 2)
4 Expatriation date. Check the box that applies (see instructions).
5 Date of notification of expatriating act, termination of residency, or claim of treaty benefits (see instructions).
6 Number of days you were physically present in the United States in the current year
7 List all countries (other than the United States) of which you are a citizen.
8 How you became a U.S. citizen

Part II For Persons Who Expatriated After June 3, 2004, and Before June 17, 2008

- 1 Did you complete Form 8854 for any period after June 3, 2004, and before June 17, 2008?
2 Were you physically present in the United States for more than 30 days but not more than 60 days during the tax year?
a If you checked "Yes" to line 2, were you performing services for an unrelated employer?
b If you checked "Yes" to line 2a, are you a citizen or resident, fully liable for income tax, in the country in which you were born, your spouse was born, or either of your parents was born?



**Part III For Persons Who Expatriated After June 16, 2008, and Before January 1, 2014**

- If you made an election to defer the payment of tax, complete line 1.
- If you have an item of eligible deferred compensation, complete line 2.
- If you have an interest in a nongrantor trust, complete line 3.

**1** Complete columns (a), (b), and (c) for all property on which you deferred tax on a prior year Form 8854. Complete column (d) for any property you disposed of in 2014 and see the instructions for Part III.

(a) Description of property	(b) Amount of mark-to-market gain or (loss) reported on prior year Form 8854	(c) Amount of tax deferred on prior year Form 8854	(d) Date of disposition (if any)

- 2** Did you receive any distributions of eligible deferred compensation items for 2014?  Yes  No  
 If "Yes," Amount of distribution: \_\_\_\_\_ Amount withheld at source, if any: \_\_\_\_\_
- 3** Did you receive any distributions from a nongrantor trust for 2014?  Yes  No  
 If "Yes," Amount of distribution: \_\_\_\_\_ Amount withheld at source, if any: \_\_\_\_\_

**Part IV For Persons Who Expatriated During 2014**

**Section A Expatriation Information**

- 1** Enter your U.S. income tax liability (after foreign tax credits) for the 5 tax years ending before the date of expatriation.
- |                     |                     |                     |                     |                     |
|---------------------|---------------------|---------------------|---------------------|---------------------|
| 1st Year            | 2nd Year            | 3rd Year            | 4th Year            | 5th Year            |
| Before Expatriation | Before Expatriation | Before Expatriation | Before Expatriation | Before Expatriation |
| \$ _____            | \$ _____            | \$ _____            | \$ _____            | \$ _____            |
- 2** Enter your net worth on the date of your expatriation for tax purposes . . . . . \$ \_\_\_\_\_
- 3** Did you become at birth a U.S. citizen and a citizen of another country, and do you continue to be a citizen of, and taxed as a resident of, that other country? . . . . .  Yes  No
- 4** If you answered "Yes" to question 3, have you been a resident of the United States for not more than 10 of the last 15 tax years? . . . . .  Yes  No
- 5** Were you under age 18½ on the date you expatriated and have you been a U.S. resident for not more than 10 years? . . . . .  Yes  No
- 6** Do you certify under penalties of perjury that you have complied with all of your tax obligations for the 5 preceding tax years (see instructions)? . . . . .  Yes  No