

PUBLICATION

New Tax Provisions Make Expatriation More Costly

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On June 17, 2008, President Bush signed into law the Heroes Earnings Assistance and Tax Relief Act of 2008 (the HEART Act). The HEART Act includes sweeping legislation covering certain individuals who expatriate after June 17, 2008. These provisions were enacted to discourage U.S. citizens and long-term residents from expatriating for tax purposes – a practice that had become popular among some high-net-worth individuals owning substantially appreciated property. The HEART Act accomplishes this goal by causing immediate and significant U.S. income tax consequences, as well as estate and gift tax consequences for certain individuals who expatriate.

The new law applies only to "covered expatriates." The HEART Act defines an expatriate as (1) a U.S. citizen who relinquishes his or her citizenship, or (2) a long-term resident of the U.S. who ceases to be a lawful permanent resident of the U.S. A covered expatriate is an expatriate who meets one of these three criteria:

- has an average annual net income for the five previous taxable years of more than \$139,000 (adjusted annually for inflation),
- has a net worth of \$2,000,000 or more on the date of expatriation, or
- has failed to comply with all U.S. tax obligations for the preceding five years.

Income Tax Consequences under the HEART Act

Under prior law, an individual who expatriated from the U.S. was subject to an alternate U.S. income tax reporting system for a ten year period from the date of expatriation. The HEART Act, however, replaces the ten year reporting requirements with a new set of mark to market rules that are codified in Section 877A of the Internal Revenue Code (the Code). The new mark to market rules treat the covered expatriate as having a deemed sale of his worldwide assets on the day prior to expatriation. Thus, the covered expatriate will have to recognize gain or loss on all his property on the day prior to expatriation for U.S. income tax purposes.

The HEART Act does exempt, however, the first \$600,000 of net gain (adjusted annually for inflation) that would be includible in gross income from the mark to market rules. Additionally, the mark to market rules will not apply to certain deferred compensation, deferred compensation retirement accounts, and any interest in a nongrantor trust (exempt property). Exempt property is subject to its own special set of rules. For example, deferred compensation is subject to a withholding tax of 30 percent of any taxable payment and nongrantor trusts are subject to a withholding tax of 30 percent of any taxable distribution.

The HEART Act further allows a covered expatriate to elect to defer the tax from the deemed sale until the earlier of (1) the due date of the return for the taxable year in which the property is disposed of, or (2) the due date of the return for the year of the expatriate's death. The deferral election comes with a price: a covered expatriate must provide adequate security, i.e., a bond or letter or credit, and pay interest equal to the interest rate applicable to underpayments (currently 5 percent). Further, once the election is made it is irrevocable and the covered expatriate must make an irrevocable waiver of any right under any U.S. treaty that would preclude assessment or collection of the tax.

U.S. Estate and Gift Tax Consequences under the HEART Act

The HEART Act also imposes a tax on a U.S. citizen or long-term resident for any "covered gift or bequest" from a covered expatriate. The tax also applies to "covered gifts and bequests" to domestic and foreign trusts. These provisions are codified in Section 2801 of the Code.

For estate and gift tax purposes, a covered gift or bequest includes all gifts and bequests above the annual exclusion (currently \$12,000) other than (1) gifts shown on a timely filed U.S. gift tax return, (2) any property included in the covered expatriate's gross estate and reported on a timely-filed U.S. estate tax return, and (3) any property that would be eligible for an estate or gift tax charitable or marital deduction if the donor were a U.S. citizen.