By **David Roberts** & **Melvin A. Warshaw**

Expatriation as an Out-of-Body Experience

Pitfalls and planning for the dreaded U.S. inheritance tax

Most U.S. cross-border tax advisors concentrate on the income tax side of expatriation. In the year when U.S. citizenship or permanent residence is given up, a special "mark-to-market" income tax is imposed on certain "covered expatriates." They must file Internal Revenue Service Form 8854 listing their worldwide assets and potentially pay a special exit tax on the appreciation in such assets in excess of a baseline exemption amount. This so-called "exit" tax is imposed at the highest U.S. capital gains rate, currently 23.8%. The tax has been well publicized when compared to its cousin, the U.S. inheritance tax under Internal Revenue Code Section 2801, which is far more pernicious and dreaded by well-versed tax advisors because it's more elusive and can endure for many years following the actual date of expatriation.

U.S. Estate Tax Reach

As domestic estate tax practitioners know, the U.S. estate tax is a wealth tax imposed on all the assets owned or controlled by a decedent at the time of death. An expatriate is either a former U.S. citizen or a permanent legal resident of the United States (Green Card holder). Expatriates typically no longer live full-time in the United States.

The U.S. estate tax is imposed on worldwide assets of a U.S. citizen or on a non-citizen who lives in the United States and is considered domiciled in the United States. "Domicile" under the U.S. transfer tax system is defined in a manner that equates to domicile under the Anglo-American common law concept.[1] "Residency" is defined for U.S. transfer tax purposes in Treasury Regulations Sections 20.0-1(b) and 25.2501-1(b). An individual becomes a U.S. domiciliary by living in a place, even for a brief period, with no present intention to leave there, and a later intent to change domicile won't be effective unless the individual actually leaves. This highly subjective test for transfer tax purposes is in stark contrast to the mechanical and objective income tax residency rules. Individuals who are citizens or Green Card holders will, with few exceptions, be considered income tax residents. Others will be subject to the substantial presence test, a bright-line test based on the number of days spent in the United States over a period of three years.[2] Domicile, on the other hand, has nothing to do with an individual's visa status. A U.S. Green Card holder living permanently outside the United States might be considered domiciled outside the United States for U.S. transfer tax purposes, even though such individual has ongoing U.S. income tax obligations on his worldwide income and must satisfy other U.S. tax reporting requirements. An individual living in the United States with no immigration status but no current intent to leave would likely be domiciled in the United States.

Someone who's neither a U.S. citizen nor domiciled in the United States for transfer tax purposes (commonly referred to as a "non-citizen, non-domiciliary" (NDND)) isn't subject to U.S. estate tax or generation-skipping transfer (GST) tax on worldwide assets. Only assets that are owned (or controlled) by the NCND individual at death and are located in the United States are subject to U.S. estate tax and GST tax (known as "U.S. situs assets"). The most obvious U.S. situs asset is real estate situated in the United States. Stock issued by U.S. corporations is less obvious, but it too is

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considered a U.S. situs asset for estate tax purposes (but not for gift tax purposes). Debts owed by U.S. individuals that are held by expatriates are also treated as U.S. situs assets and may include certain U.S. bonds. As such, an individual who expatriates from the United States may nonetheless continue to have exposure to the U.S. estate tax and GST tax on assets that he leaves behind in the United States. These assets must be reported on a U.S. estate tax return (Form 706-NA) with only a very limited $60,000 exemption amount.

Who's an Expatriate?

An "expatriate" is a former U.S. citizen or long-term resident. A "long-term resident" is an individual who's been a permanent legal resident of the United States (that is, a Green Card holder) during eight of the previous 15 years. This is often referred to as the "8-of-15 year test."

Often, the best and easiest immigration strategy isn't ideal from a U.S. tax perspective.

The act of expatriation itself is relatively straightforward and ordinarily the result of an affirmative action by the individual. An affirmative act of expatriation would typically occur when the individual formally renounces citizenship or the long-term resident voluntarily gives up his Green Card. Abandoning Green Card status is typically accomplished by filing with the U.S. Citizenship and Immigration Service (USCIS) or a consular officer a USCIS Form I-407.

Any individual who's planning on expatriation and his U.S. tax advisor are likely aware of the significant U.S. income tax consequences (exit tax liability) that can occur when the act of expatriation results in the dreaded "covered expatriate" status. This status can come into play when an expatriate satisfies any one of three criteria: He (1) has a prior U.S. tax compliance failure, (2) exceeds an average income tax liability, or (3) exceeds a net worth threshold. Different planning before and after expatriation may be appropriate depending on whether an individual is a covered expatriate. Sometimes, there may be uncertainty whether an expatriating executive of a start-up, private company is above the net worth threshold because this often comes down to a question of the value of illiquid stock in a non-public company that's subject to a stock restriction agreement. An outside appraisal is highly recommended.

Certifying Full Compliance

An individual is a covered expatriate if he has a prior U.S. tax non-compliance issue. An expatriating Green Card holder must certify to the IRS on Form 8854 that he's in full compliance with all U.S. tax obligations for the last five years. Most foreign executives are provided with U.S. tax return preparation services of a qualified accounting firm with international tax expertise, so non-compliance is unlikely. However, for those long-term Green Card holders who didn't engage knowledgeable U.S. tax preparation services on entering the United States, this prong of the statute can be difficult to overcome without now engaging a U.S. tax accountant to undertake a costly and time-consuming forensic-like analysis of the preceding five taxable years of U.S. tax filings.

Compliance failures can include failing to file U.S. income tax returns, report income or pay tax due. Even more problematic is that a prior tax compliance failure also includes failing to electronically file a FinCen Form 114 Report of Foreign Bank and Financial Accounts (FBAR) with the U.S. Treasury. Long-term Green Card holders who are U.S. taxpayers may have failed to file any one of a number of U.S. information returns including for a controlled foreign corporation (CFC) (Form 5471) or perhaps the somewhat duplicative Form 8938. Tax compliance is required for all information returns that aren't even tax returns. This imposes a very high bar for many Green Card holders to satisfy, especially those living outside of the United States, as English isn't their first language, and they may be unfamiliar with the intricacies of the U.S. tax system.

Covered Expatriate Status

IRC Section 877A exit tax. Once considered a covered expatriate, the individual will be deemed to have sold all of his worldwide assets at a fair market value (FMV) on the date of expatriation. Any resulting gain

in excess of the allowable exemption of $725,000 (inflation adjusted amount in 2019) is taxed at the top capital gains tax rate of 23.8%. Various nuances can apply for assets that aren't realizable, such as deferred compensation arrangements and options to defer payment of the tax on illiquid assets (subject to an interest change). Cash isn't a realizable asset.

IRC Section 2801 inheritance tax. The lesser known cousin of the exit tax, the inheritance tax, can be far more draconian in applying to wealth accumulated outside the United States long after terminating Green Card status and can apply to U.S. beneficiaries who weren't even born when an individual abandoned Green Card status. This inheritance tax provision has been part of the U.S. Tax Code since 2008.

A U.S. individual who inherits assets (or receives a gift or foreign trust distribution) from a covered expatriate must pay a U.S. inheritance tax under Section 2801. This is the opposite of the U.S. estate tax that taxes the transferor; here, the U.S. recipient pays a U.S. tax because of the covered expatriate status of the former long-term Green Card holder on the date of formally abandoning Green Card status (or former U.S. citizen on the date of turning in his U.S. passport).

The inheritance tax rate is the highest gift tax rate in existence at the time of the inheritance (currently 40%). Unlike the U.S. gift tax, which is tax exclusive, the U.S. inheritance tax is tax inclusive. The gift tax under Chapter 12 is imposed on the amount the donee receives, whereas the inheritance tax under Chapter 15 is imposed on the gross value received by U.S. heirs. The inheritance tax is reduced by gift or estate tax paid to a foreign country on such transfer.

A most difficult feature of the inheritance tax to grasp is that it takes effect on the date of expatriation by a Green Card holder and continues in perpetuity until all assets of such individual have been

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