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Breaking Developments in Tax Law

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Expatriation from the United States by U.S. Citizens and Long-Term Residents Triggers a Deemed Taxable Sale of Assets

The Heroes Earnings Assistance and Relief Tax Act of 2008 ("HEART") was signed into law on June 17, 2008. HEART, which was passed overwhelmingly by both the House and Senate in late May of 2008, generally amends the Internal Revenue Code of 1986 to provide certain tax relief and incentives for members and veterans of the U.S. armed forces. However, HEART also imposes significant and unexpected tax consequences on certain U.S. citizens and long-term residents expatriating from the United States ("Expatriates") on or after its enactment.

Deemed Disposition – The Exit Tax

HEART amends the Internal Revenue Code of 1986 by adding Section 877A(a), which treats certain Expatriates as having disposed, at fair market value, all assets owned on the day prior to the date of expatriation (*i.e.*, the date on which U.S. citizenship/residency was terminated). Unless an election is made under new Section 877A(b) to defer the applicable tax, net gain from the deemed sale in excess of $600,000, as adjusted for inflation, will be subject to U.S. federal income tax in that year. In effect, Section 877A(a) imposes an exit tax on the Expatriate's departure from the United States.

Section 877A only applies to "covered" Expatriates – *i.e.*, those who:

- Have an annual average net income tax greater than $124,000 for the past 5 years;
- Have a net worth in excess of $2,000,000; or
- Fail to certify under penalties of perjury that all obligations imposed under the Internal Revenue Code have been satisfied for the past 5 years.

As noted above, Expatriates will have an option to defer the tax imposed under Section 877A(a) on the deemed disposition of specified assets by making an irrevocable election and posting proper security. A validly made election will effectively defer the recognition of any applicable tax until the earlier of the asset's actual disposition or the Expatriate's death.

Deferred Compensation and Nongrantor Trust Distributions

Section 877A also provides special rules for the treatment of deferred compensation, such as pension plans, IRAs, 401(a) and 403(b) plans, stock option rights, etc., and nongrantor trust distributions.

Section 877A(d) imposes a 30 percent U.S. withholding tax on the payment of eligible deferred compensation to an Expatriate. Eligible deferred compensation includes any deferred compensation paid by a U.S. person, or a person electing to be treated as a U.S. person, to an Expatriate who has both notified the payor of their expatriate status and made an irrevocable waiver of any right under an applicable treaty to a reduced rate of withholding. In contrast, Section 877A(d) treats non-eligible deferred compensation to which an Expatriate is entitled to receive as paid on the day prior to expatriation in an amount equal to the present value of the Expatriate's accrued benefits.

In addition, Section 877A(f) subjects the taxable portion of a distribution from a nongrantor trusts to a 30 percent U.S. withholding tax. The taxable portion of a nongrantor trust distribution is defined as that portion of the distribution that would be subject to U.S. federal income tax if the recipient were still a U.S. citizen or resident. Moreover, if the fair market value of property distributed from the nongrantor trust exceeds its adjusted basis, the trust will recognize income as if the property were sold outright to the Expatriate. As written, this provision appears to have an extremely broad scope and would thus presumably apply to distributions from foreign and U.S. trusts alike for an unlimited time period.

Summary

Regulations will be needed to define and clarify the scope of Section 877A. However, based on the statutory text, it is evident that U.S. citizens and long-term residents considering terminating their ties with the United States by way of expatriation may be subject to significant and unexpected U.S. federal income tax consequences by doing so. As a result, it is imperative that those considering expatriation undertake a detailed analysis of their assets to determine the full impact of these new rules.

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