International Tax Strategies

By David Buss, David Hryck and Alan Granwell *

The U.S. Tax Consequences of Expatriation: Is It a Tax Planning Opportunity or a Trap for the Unwary?

U.S. citizens and tax residents are subject to U.S. income tax on their worldwide income and to estate and gift taxation on their transfers of real, tangible and intangible property, wherever located.[1] In other words, a U.S. citizen or resident can run but ultimately can't hide.

In contrast, a nonresident alien individual[2] generally is subject to U.S. income tax at graduated rates only on income effectively connected to a U.S. trade or business and a 30-percent tax, or a reduced treaty rate, on certain U.S. source passive type income, known as fixed or determinable, annual and periodical income, or "FDAP."[3] U.S. source capital gains (except gains from the disposition of a U.S. real property interest) generally are not subject to U.S. capital gains taxation.[4] Estate tax is imposed only on U.S.-situs property and gift tax is imposed only on transfers of tangible personal property having a situs within the United States and not on transfers of intangible property, regardless of where situated.[5] The U.S. tax regime applicable to nonresident aliens is imposed on a much narrower tax basis than is the case for U.S. citizens and residents. Therefore, putting aside the significant nontax considerations, the act of expatriation or giving up one's U.S. citizenship can significantly reduce a taxpayer's U.S. income, estate and gift tax exposure, including generation-skipping transfer tax. Should an individual be willing to take this extreme step, the only tax hurdle that must be cleared to become subject to the tax system applicable to nonresident aliens is Code Sec. 877, a provision designed to disincentivize taxpayers from expatriating for tax avoidance purposes.[6] On closer inspection, though, Code Sec. 877 does not significantly limit the benefit of expatriation to

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certain taxpayers and provides significant tax planning opportunities for someone willing to take this step. Care must be taken, however, in navigating Code Sec. 877, as it contains some traps for the unwary and provides unusual results in certain situations.

Persons Subject to Code Sec. 877

Code Sec. 877 applies to a U.S. citizen who relinquishes citizenship and a long-term resident that relinquishes residency if (i) the average annual net income tax of such individual for the five year period ending before the date of expatriation exceeds $124,000 (subject to a cost of living adjustment)[7]; (ii) the net worth of the individual is $2 million or more; or (iii) the individual fails to certify under penalty of perjury that he has met certain requirements for the five tax years preceding expatriation by filing Form 8854.[8] A long-term resident means a person who is a "green card" holder in at least eight tax years during the 15–tax year period ending on (i) the date of "green card" relinquishment or (ii) commencement of residency in a foreign country under the provisions of a U.S. bilateral income tax treaty and does not waive treaty benefits.[9] Note that long-term residents do not include persons that are subject to U.S. taxation on a residence basis solely as a result of their substantial presence in the United States. Long-term residents subject to Code Sec. 877 may elect to step-up the tax basis of their assets to their fair market value as of the date U.S. citizenship was obtained for purposes of computing their tax liability under the alternative Code Sec. 877 tax regime discussed below.[10]

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Alternative Code Sec. 877 Tax Regime

A nonresident alien individual subject to Code Sec. 877 will continue for a 10-year period subsequent to expatriation ("the 10-Year Period")[11] to be subject to U.S. tax at graduated rates. For this purpose, in computing taxable income, gross income shall include only (i) U.S. source gross income which is not effectively connected to a U.S. trade or business—that is, U.S. source passive income; and (ii) gross income, regardless of source, which is considered effectively connected with the conduct of a trade or business in the United States.[12] Deductions other than capital loss carryovers are permitted only to the extent they are connected to items of gross income described in (i) and (ii) above.[13] This alternate income tax regime will only apply to the extent it results in a greater tax liability then would be imposed on the expatriate if he or she were treated as a nonresident alien.[14]

Example 1. The year after Taxpayer X expatriates to a non–treaty jurisdiction, she has U.S. source interest income of $1,000 and related interest expense of $600. As a nonresident, Taxpayer X would be subject to a 30-percent gross tax of $300 on her interest income without the ability to benefit from her investment expenses. U.S. tax computed under the alternative Code Sec. 877 tax regime yields a federal income tax liability of $140 ($1,000 – $600 x 35%). Because Taxpayer X's tax liability is greater as a nonresident, Code Sec. 877 will not apply to Taxpayer X in this year.

If a former citizen or long-term resident subject to the alternative tax regime dies within the 10-Year Period, the decedent's estate continues to include that part of the gross estate situated in the U.S. plus a portion of the value of certain stock in foreign corporations that own U.S.-situs assets if (i) the decedent owned, directly or indirectly, at death 10 percent or more of the combined voting power of all voting stock of the corporation; and (ii) the decedent owned, directly or indirectly, at death more than 50 percent of the total voting stock of the corporation or more than 50 percent of the total value of all stock of the corporation ("Closely Held Foreign Stock").[15] This is designed to prevent an expatriate from transferring U.S.-situs assets subject to U.S. estate tax to a foreign corporation, the stock of which would not otherwise be subject to U.S. estate tax. In the end, though, the expatriate is subject to U.S. estate tax on essentially the same base of assets as a nonresident alien plus any Closely Held Foreign Stock. However, if the decedent violates the 30-day rule discussed below, the estate tax would be imposed on that decedent's worldwide assets.

Under the alternative Code Sec. 877 tax regime, a former citizen or long-term resident is subject to gift tax on gifts above the annual exclusion of U.S.-situs intangibles, such as stock in domestic companies, made during the 10-Year Period, plus gifts of Closely Held Foreign Stock.[16] Further, if the 30-day rule discussed below is violated, gift tax will be imposed on the transfer of any asset, regardless of its character or location.[17] This is more expansive then the general rule that subjects nonresident aliens not subject to Code Sec. 877 to gift tax only with respect to transfers of tangible personal property with a U.S. situs.[18]

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Items Not Encompassed Under Code Sec. 877

The alternative tax regime of Code Sec. 877 has no application to (i) non–U.S. source income that is not effectively connected with a U.S. trade or business earned subsequent to expatriation; and (ii) all income, regardless of source, earned after the 10-Year Period. This definition of income subject to Code Sec. 877 may be opportune for an individual that has significant activities outside of the United States. This is because income subject to the Code Sec. 877 rule does not encompass a significant portion of income that is likely to be generated by an individual considering expatriation—that is, someone who already has significant business activities outside the United States. For these individuals, because foreign source passive income and trade or business income (not effectively connected to a U.S. trade or business) completely escapes the Code Sec. 877 net, expatriation provides immediate U.S. tax savings. This result has policy justification in that the income that is generated is derived from outside the United States. Further, even if an individual considering expatriating currently holds assets that would generate income encompassed by Code Sec. 877, that individual will not be taxable on such income after the expiration of the 10-Year Period. However, the estate tax implications must be considered in this context.

Example 2. Taxpayer X, who owns (either directly or through a flow-through entity) a factory outside of the United States that generates entirely non-U.S. source income, expatriates on December 31, 2006. During 2007 Taxpayer X is in the United States for less than 30 days. All of Taxpayer X's income generated by his factory during 2007 is completely free from U.S. income tax.

Example 3. Taxpayer X expatriates on December 31, 2006. On January 1, 2017, Taxpayer X sells shares at a significant gain in a U.S. corporation that is not a U.S. real property holding corporation. For 2017, Taxpayer X is taxed as a nonresident alien. As such, capital gains are not subject to U.S. tax and therefore no U.S. tax results.

Persons Not Subject to Code Sec. 877

Even if the income and net-worth tests are met, certain dual citizens and minors are still not subject to Code Sec. 877 under the theory that expatriation, in these circumstances, was not undertaken for a tax motivated purpose. Note that these exceptions to the application of Code Sec. 877 only apply to loss of citizenship and not to long-term residents relinquishing a "green card" or becoming residents of another country under the "tie-breaker" provisions of a bilateral income tax treaty.

Code Sec. 877 does apply to a dual resident who at birth became both a U.S. citizen and a citizen of another country and continues to be a citizen of another country up to the time of expatriation, provided the individual has no substantial contacts with the United States prior to expatriation. An individual is treated as having no substantial contacts with the United States if he (i) was never a resident of the United States, (ii) has never held a U.S. passport, and (iii) was not present in the U.S. for more than 30 days during any calendar year in the 10-Year Period.

A minor will also be exempt from Code Sec. 877 if (i) he became at birth a citizen of the United States, (ii) neither of his parents was a citizen of the United States at the time of his birth, (iii) his loss of U.S. citizenship occurs before he attains age 18 1/2, and (iv) he was not present in the United States for more than 30 days during any calendar year that is one of the 10 calendar years immediately preceding his loss of United States citizenship.

Not Quite Clear Sailing

In an effort to put more teeth in Code Sec. 877, the provision contains (i) a more expansive definition of U.S. source income subject to tax during the 10-Year Period[19]; (ii) a 30-day rule triggering imposition of U.S. tax, computed as if the expatriate were still a citizen[20]; (iii) a gain recognition requirement on certain exchanges[21]; and (iv) a special rule for property contributed to a controlled corporation.[22]

Special Definition of U.S. Source

U.S. source income, for purposes of Code Sec. 877, includes:

(A) Gain on the sale or exchange of U.S.-situs property (other than stock or debt obligations). Normally gain on this type of property is sourced according to the seller's residence.[23]

(B) Gain on the sale or exchange of stock issued by a domestic corporation or debt obligations of U.S. persons or the U.S., a state or political subdivision

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thereof, or the District of Columbia. Normally gain on this type of property is also sourced according to the seller's residence.[24]

(C) Any income or gain derived from stock in a foreign corporation if the individual losing U.S. citizenship owned at any time during the two-year period ending on the date of the loss of citizenship, more than 50 percent of the vote or value of such corporation, but only to the extent such gain does not exceed the earnings and profits generated during the two-year period prior to the loss of citizenship.

Example 4. Taxpayer X, who relinquishes citizenship on December 31, 2006, owned 100 percent of Foreign Corporation Y since January 1, 2000. Foreign Corporation Y has earnings and profits of $2,000, only $200 of which were generated since January 1, 2004. Foreign Corporation Y stock is sold for a gain of $5,000, but only $200 is taxed under Code Sec. 877, the earnings and profits generated in the two years prior to expatriation.

30-Day Rule

The American Jobs Creation Act of 2004[25] added a significant disincentive to expatriation. Effective for individuals who expatriate after June 3, 2004, Code Sec. 877 no longer applies during the 10-Year Period in any year in which such individual is physically present in the United States on more than 30 days in the calendar year. In this case, such individual is taxed as a U.S. citizen or resident, that is, on his or her worldwide income. If the individual dies during that year, his worldwide estate will be subject to U.S. estate tax. All gifts made during that year will likewise be subject to U.S. gift tax. While this does not make the tax situation of an expatriating *citizen* worse than had he or she not expatriated, it does put a *long-term resident* in a worse position. Normally a long-term resident that is not a U.S. domiciliary is subject to (i) U.S. estate tax only on his or her U.S.-situs property and (ii) U.S. gift tax on U.S. situs tangible personal property. A long-term resident that is subject to Code Sec. 877 and stays in the United States more than 30 days, however, will be subject to U.S. estate and gift tax on his worldwide assets, regardless of his domicile.

While admittedly this decreases the incentive to expatriate for those unable or unwilling to avoid presence in the U.S. for 30 days or more, the 30-day rule has one fatal flaw. It does not toll the 10-Year Period. So, even for taxpayers willing to expatriate but unwilling to minimize U.S. presence, the 30-day rule merely makes such taxpayer wait 10 years to achieve the tax benefits of expatriation. Except for the collateral consequences of expatriation discussed later, the additional reporting requirements and the increased U.S. estate and gift tax consequences to a long-term resident, the 30-day rule merely puts the expatriating taxpayer in the same tax position for 10 years that he or she would have been in had no expatriation taken place; no better or worse. After the 10-Year Period, all of the tax benefits spring into existence.

Note, in applying the 30-day rule, certain days of presence do not count. Days performing services for an employer are disregarded so long as the employer is not related to the expatriating individual.[26] No more than 30 days may be disregarded under this exception, so at best, a taxpayer would only be able to spend up to 60 days in the United States without being taxed as a citizen or resident.

The 30-day rule will also not apply if, within a reasonable time of expatriation, an individual becomes a citizen or resident of his country of birth, country of his spouse's birth, or country in which his parents were born, so long as he is fully liable for tax under that country's laws.

The 30-day rule will also not apply to someone who has spent 30 days or less in the United States in each year of the 10-year period preceding expatriation.

Gain Recognition on Certain Exchanges

As mentioned, an expatriate's U.S. source income generated within the 10-Year Period is subject to U.S. tax. To prevent tax-free exchanges during the 10-Year Period from ameliorating this rule, immediate gain recognition is required on what would otherwise be a tax-free exchange of property that would produce U.S. source income upon disposition for property that would produce foreign source income (*e.g.,* the transfer of U.S. stock to a foreign corporation in exchange for its stock).[27] Gain in this case is determined as if the property had been sold for its fair market value on the date of such exchange. The only way to prevent gain recognition in this case is for the taxpayer to enter into a gain recognition agreement to treat the gain derived from the sale of the property received in the exchange during the 10-Year Period as U.S. source income. However, any gain recognition agreement terminates if the transferred property is disposed of by the acquirer within the 10-Year Period. In these

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cases, an expatriate exchanging property subject to a gain recognition agreement would be well advised to contractually prohibit the transferee from selling such property within the 10-Year Period.

Property Contributed to a Controlled Corporation

Under Code Sec. 877(d)(4), when an expatriate that would otherwise be a U.S. shareholder under Code Sec. 951(b) contributes U.S.-situs property to a controlled foreign corporation,[28] any gain on such property generated in the 10-Year Period will be treated as received directly by the individual. Gain on sale of the stock in such corporation will be taxable to the expatriate to the extent of the gain that would have been recognized by the corporation had it sold a *pro rata* share of the contributed property.

Renouncing U.S. Citizenship

Those intrigued with expatriation will have to comply with the specific requirements for an effective renunciation. Although a U.S. citizen may renounce or lose U.S. citizenship in a number of ways, the most common is by formally renouncing U.S. citizenship after having acquired citizenship in another country.[29] An individual can formally renounce U.S. citizenship by making an Oath of Renunciation before a U.S. diplomatic or consular officer abroad, which will usually involve two meetings. During the first, the person is informed of the legal consequences of the contemplated renunciation, and during the second meeting, the actual Oath is made. Ordinarily, the person will also be required to present evidence of having acquired another nationality, presumably to assure that the person does not become stateless, which would leave open the risk of deportation from every country in the world. Thereafter, the Department of State will confirm the renunciation by issuing a Certificate of Loss of Nationality within four to six months.

Importantly, for tax purposes an individual will not be considered to have expatriated unless he or she has both (i) given notice of an expatriating act or termination of residency (with the requisite intent to relinquish citizenship or terminate residency) to the Secretary of State or the Secretary of Homeland Security, and (ii) made a statement in accordance with Code Sec. 6039G by filing Form 8854.[30] This creates an unusual result for long-term residents. If a taxpayer meets the Code Sec. 877(e)(2) definition of long-term resident and becomes a resident of another country under a treaty "tie-breaker" provision, the individual will continue to be treated as a U.S. resident until the date Form 8854 is filed. This can have peculiar results since normally an individual will elect treaty "tie-breaker" status after the year with the filing of his or her income tax return. This "glitch" would appear to raise concerns under U.S. bilateral income tax treaties because from the perspective of our treaty partner, the individual would be treated as a resident of that treaty country rather than the United States.[31]

Annual Return

Expatriating individuals are required to file an annual return using Form 8854 for each year in the 10-Year Period,[32] whether or not a return would otherwise be due. The return collects information designed to insure compliance with Code Sec. 877 and failure to file results in a $10,000 penalty, absent reasonable cause.

Nontax Effects of Expatriation

Under Act Sec. 352(a) of the Illegal Immigration Reform and Immigrant Responsibility Act of 1996 (also commonly referred to as the "Reed Amendment"), a taxpayer who renounces his U.S. citizenship "to avoid tax" (as determined by the Attorney General) is ineligible to receive a U.S. visa and would therefore be unable to enter the United States.[33] Following the Reed Amendment, former citizens are now grouped with other miscellaneous persons, whose admission to the United States may or will be denied, such as practicing polygamists, unlawful voters, and international child abductors.[34]

The Attorney General has not adopted regulations to implement the Reed Amendment and in fact, as far as we are aware, the Reed Amendment has never been applied to exclude a former U.S. citizen from entry to the United States.

A former citizen will, though, automatically be classified as an alien and will become subject to the U.S. visa rules that apply to citizens of his or her nationality. Therefore, in addition to the (admittedly small) risk of being denied admission under the Reed Amendment, a former citizen also becomes subject to all other grounds of inadmissibility that may apply to his or her "new" nationality.

Should an expatriate ever wish to become a U.S. permanent resident or U.S. citizen again following

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expatriation, the U.S. rules on acquiring citizenship would apply in the same manner as to other citizens of his new home country.

Proposals to Modify Current Law

There have been a number of proposals to further disincentivize expatriation by imposing a capital gain tax on a "mark-to-market" basis upon an individual's relinquishing citizenship or terminating residency.[35] Such proposals would subject such individuals to U.S. tax on the net unrealized gain with respect to their worldwide assets as if such property were sold for its fair market value on the date of citizenship relinquishment or residency termination. A number of variations of this proposal have been put forth and it is likely that there will be continuing legislative interest in this issue.

Conclusion

Whether to relinquish citizenship or long-term residency is an important decision that goes far beyond taxation. However, an individual considering this option must take into account the tax consequences resulting from that action. As can be seen from above, this area is complex, has a number of ambiguous rules and must be carefully evaluated so that the expatriating individual knows what he or she is in for upon expatriation from a tax perspective.

Endnotes

* For additional information, contact David Buss (*david.buss@dlapiper.com*), David Hryck (*david.hryck@dlapiper.com*) and Alan Granwell (*alan.granwell@dlapiper.com*).

1 Code Secs. 61, 2031, 2501(a).

2 Note, the Code utilizes a different definition for nonresident with respect to income tax and transfer taxation purposes. For income tax purposes, a nonresident is an individual that satisfies the substantial presence test or the green card test. For transfer tax purposes, a nonresident is an individual that is not domiciled within the United States. Code Sec. 7701(b).

3 Code Sec. 2(d).

4 Code Sec. 871(a)(2).

5 Code Secs. 2103 and 2501(a)(2).

6 This article does not deal with the critical aspect that an expatriating U.S. citizen must obtain a passport since he or she is relinquishing his or her U.S. passport. As discussed below, the expatriation provisions also apply to certain "green card" holders.

7 For this purpose, the average annual income tax is defined in Code Sec. 38(c)(1). For 2007 the cost of living adjusted amount is $136,000. Rev. Proc. 2006-53, IRB 2006-48, 996.

8 Code Sec. 877(a)(2).

9 Code Sec. 877(e). For this purpose, a taxpayer will not be considered a lawful permanent resident for any tax year if he is treated as a resident of a foreign country under the tie breaker provisions of a bilateral U.S. income tax treaty.

10 Code Sec. 877(e)(3)(B).

11 The 10-Year Period is suspended for sales or exchanges of property during the period the risk of loss with respect to such property is diminished. Code Sec. 877(d)(3).

12 Code Sec. 877(b).

13 The deductions allowed under Code Sec. 873(b) are also allowed. Code Sec. 877(b).

14 Code Sec. 877(a).

15 Code Secs. 2107(a) and 2107(b).

16 Code Secs. 2501(a)(3) and 2501(a)(5).

17 Code Sec. 877(g)(1).

18 Code Sec. 2301(a)(2).

19 Code Sec. 877(d).

20 Code Sec. 877(g).

21 Code Sec. 877(d)(2).

22 Code Sec. 877(d)(4).

23 Code Sec. 865(a).

24 Code Sec. 865(d).

25 American Jobs Creation Act of 2004 (P.L. 108-357).

26 Regulations, when issued, are expected to contain provisions to prevent abuse of this exception.

27 Code Sec. 877(d)(2). Regulations, when issued, may in certain cases extend the period of application, beginning five years before loss of citizenship.

28 As defined in Code Sec. 957.

29 The procedure for expatriation is governed by Act Sec. 349(a) of the Immigration and Nationality Act (INA). 8 USC §1481(a), which sets forth the specific actions a person must take to renounce U.S. citizenship.

30 Code Sec. 7701(n).

31 Note, that if a long-term "green card" holder elects to be treated as a resident of a treaty country under a treaty "tie-breaker" provision, he will have expatriated and the U.S. estate and gift tax expatriation rules will apply to that individual even though that person may not have been a domiciliary of the United States prior to expatriation. This is a potential trap for the unwary.

32 Code Sec. 6039G.

33 Act Sec. 352(a) of the Illegal Immigration Reform and Immigrant Responsibility Act of 1996 (P.L. 104-208).

34 8 USC §1182(a)(10).

35 The Clinton Administration's Fiscal Year 2001 Budget Proposal, a bill introduced on October 17, 1999, by Representatives Rangel and Matsui (H.R. 3099) and similar bills introduced on June 26, 2002, by Representatives Rangel and Gephart (H.R. 4880), and on July 22, 2002, by Senators Harken and Stabenaw.

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