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MEMORANDUM TO CLIENTS AND COLLEAGUES REGARDING NEW TAX RULES APPLYING TO EXPATRIATES

On June 17, 2008, President Bush signed into law the Heroes Earnings Assistance and Relief Tax (HEART) Act, which substantially changes the tax regime applying to people who relinquish U.S. citizenship or residency. This memorandum summarizes the new regime.

Background

Individuals who are treated as non-resident aliens (NRAs) for Federal income tax purposes are subject to U.S. income tax at a flat rate of 30 percent (or lower, if a treaty applies) on U.S.-source income, and at regular marginal rates on income derived from a U.S. trade or business. NRAs are subject to U.S. estate tax on U.S.-situs property, including U.S. real estate, tangible property located in the U.S., and stock in a U.S. corporation. NRAs are subject to U.S. gift tax on gifts of U.S.-situs property (such as real estate and tangible property located in the U.S.), but not on intangible property, whether located in or outside the U.S.

To discourage U.S. citizens and long-term residents from relinquishing U.S. citizenship or long-term residency¹ (referred to as “expatriation”) to avoid U.S. taxes on their worldwide income and assets, current law provides that, unless an exception applies,² an individual who expatriates is subject to U.S. income tax on U.S.-source income at the rates applicable to U.S. citizens for a period of 10 years after the date of expatriation. In addition, if the expatriate dies during that 10-year period, he or she is subject to U.S. estate tax on certain closely-held foreign stock if the foreign corporation owns U.S.-situs assets. The expatriate is subject to gift tax on gifts of (1) U.S.-situs intangible property and (2) certain closely-held foreign stock, if the foreign corporation owns U.S.-situs assets, made during the 10 years following the date of expatriation.

If the expatriate is present in the U.S. for more than 30 days in any given year, he or she is treated as a U.S. citizen or resident for that year and, therefore, is subject to U.S. income tax on his or her worldwide income. If the expatriate dies during that year, the individual's worldwide estate is subject to U.S. estate tax. The individual also is subject to U.S. gift tax on any gifts of his or her worldwide assets during that taxable year.

¹ A “long-term resident” is an individual who is a lawful permanent resident of the U.S. for at least 8 out of the 15 years ending with the year in which the individual ceases to be a U.S. lawful permanent resident or begins to be treated as a resident of a foreign country under a tax treaty.

² To meet the exception, the expatriate must either (1) establish that his or her average annual net income tax liability for the 5 preceding years does not exceed \$124,000 (adjusted for inflation after 2004) and his or her net worth is less than \$ 2 million, or (2) satisfy limited criteria for certain dual citizens and minors who have had no substantial contacts with the U.S. The expatriate also must certify that he or she has complied with all U.S. Federal tax obligations for the preceding five years.

The expatriate is required to file an annual return for each of the 10 years in which he or she is subject to the foregoing regime, even if no U.S. Federal income tax is due. The penalty for failure to file or to include all required information is \$ 10,000.

New Regime

The HEART Act replaces the current regime for so-called “covered expatriates” who expatriate after the date of enactment. A “covered expatriate” is defined as any U.S. citizen who relinquishes citizenship and any long-term resident who terminates U.S. residency,³ if he or she (1) has an average annual net income tax liability for the 5 years ending on the date of expatriation exceeding \$124,000 (adjusted for inflation after 2004); (2) has a net worth of \$2 million or more on the date of expatriation; or (3) fails to certify under penalties of perjury that he or she has complied with all U.S. Federal tax obligations for the preceding 5 years.⁴

Mark-to-Market Tax.

A covered expatriate is subject to U.S. income tax on the net unrealized gain in his or her assets as if the assets had been sold for fair market value on the day before the expatriation (referred to as the “mark-to-market tax”). Net gain on the deemed sale is recognized to the extent it exceeds \$ 600,000 (indexed for cost of living after 2008). Any subsequently-realized gains or losses are adjusted for gains and losses taken into account under the deemed sale rules, without regard to the \$ 600,000 exemption.

A covered expatriate may elect to defer payment of the mark-to-market tax up to the due date of the return for the taxable year of his or her death. The election is irrevocable and is made on a property-by-property basis. The covered expatriate must furnish a bond (or other acceptable form of security) to the Secretary of the Treasury. If the covered expatriate makes the election, the deferred tax attributable to each property is due on the due date of the return for the taxable year in which the property is disposed of. The amount of tax due is the portion of the total mark-to-market tax attributable to that property, plus interest at the rate applicable to individual underpayments for the period the tax was deferred.

Taxation of Deferred Compensation Items and Tax-Deferred Accounts.

The Act adds provisions to ensure that payments of deferred compensation items to a covered expatriate are subject to U.S. income tax.⁵ For certain deferred compensation items,

³ The Act provides that an individual ceases to be treated as a lawful permanent resident of the U.S. for tax purposes if he or she commences to be treated as a resident of a foreign country under a tax treaty between the U.S. and such foreign country, does not waive the treaty benefits applicable to residents of the foreign country, and notifies the Secretary of the Treasury of the commencement of such treatment.

⁴ There are exceptions for two types of expatriate: (1) an individual who was born with dual U.S. and foreign citizenship, if (i) as of the expatriation date the individual continues to be a citizen, and is taxed as a resident, of the other country, and (ii) the individual has been a U.S. resident for less than 10 of the 15 years ending with the year of expatriation; and (2) a U.S. citizen who relinquishes U.S. citizenship before reaching age 18 1/2, if the individual was a U.S. resident for less than 10 years prior to expatriation.

⁵ A “deferred compensation item” includes (i) any interest in a plan or arrangement described in I.R.C. § 219(g)(5) (which includes all common deferred compensation plans, such as qualified plans and IRAs), (ii) any

referred to in the Act as “eligible deferred compensation items,”⁶ the payor must deduct a 30% withholding tax from a “taxable payment” to the covered expatriate. A taxable payment is subject to withholding if it would be included in the covered expatriate’s gross income if he or she were taxed as a U.S. citizen or resident.

If a deferred compensation item is not an eligible deferred compensation item, an amount equal to the present value of that item is deemed to have been received on the day before the expatriation date. If a deferred compensation item is subject to I.R.C. § 83, the item is treated as becoming transferable and no longer subject to a substantial risk of forfeiture on the day before the expatriation date. However, these deemed distributions are not subject to any early distribution tax penalty that otherwise would apply. In addition, these rules do not apply to deferred compensation items that are attributable to services performed outside the U.S. while the covered expatriate was not a U.S. citizen or resident.

If a covered expatriate holds any interest in a specified tax deferred account⁷ on the day before the expatriation date, he or she is deemed to have received a distribution of the entire account on the day before the expatriation date. Again, this deemed distribution is not subject to any early distribution penalty that otherwise would apply.

Treatment of Interests in Trusts.

The assets of any trust that is treated as a grantor trust with respect to a covered expatriate are subject to the mark-to-market tax. Even if that trust subsequently becomes a nongrantor trust, the trust remains a grantor trust for purposes of the mark-to-market tax.

If a covered expatriate is a beneficiary of a trust as of the expatriation date, the mark-to-market tax does not apply if the trust is not treated as a grantor trust with respect to a covered expatriate immediately before the expatriation date. However, if the trust makes a direct or indirect distribution to a covered expatriate, the trustee must withhold from the distribution an amount equal to 30 percent of the portion of the distribution which would be includible in the covered expatriate’s gross income if he or she were subject to tax as a U.S. citizen or resident. The covered expatriate may not benefit from any reduction in withholding under a tax treaty. If the trust distributes appreciated property to a covered expatriate, the trust must recognize gain as if the property were sold to the covered expatriate at its fair market value.

If a trust that is a nongrantor trust immediately before the expatriation date subsequently becomes a grantor trust with respect to a covered expatriate, the conversion is treated as a distribution of the trust assets to the covered expatriate. Finally, if a domestic trust becomes

interest in a foreign pension plan or similar retirement arrangement, (iii) any item of deferred compensation, and (iv) any property, or right to property, which the individual is entitled to receive in connection with the performance of services to the extent not previously taken into account under I.R.C. § 83.

⁶ An “eligible deferred compensation item” is any deferred compensation item with respect to which (i) the payor is either a U.S. person or a non-U.S. person who elects to be treated as a U.S. person for purposes of withholding, and (ii) the covered expatriate notifies the payor of his status as a covered expatriate and waives any claim of withholding reduction under a tax treaty.

⁷ Specified tax-deferred accounts include individual retirement plans defined in I.R.C. § 7701(a)(37), section 529 plans, Coverdell education savings accounts, health savings accounts, and Archer MSAs.

a foreign trust as the result of an individual's expatriation, the general income tax rules regarding transfers to foreign trusts by U.S. persons will apply.

Treatment of Gifts and Bequests from Expatriates.

The Act imposes an additional tax on "covered gifts or bequests" to a U.S. citizen or resident. A covered gift or bequest is any property acquired (i) by gift from an individual who is a covered expatriate at the time of acquisition, or (ii) by reason of the death of an individual who was a covered expatriate immediately before death.⁸ The tax is an amount equal to the product of (i) the highest marginal estate tax rate, or, if greater, the highest marginal gift tax rate, as in effect on the date of receipt; and (ii) the value of the covered gift or bequest.

The tax is imposed upon the *recipient* of the covered gift or bequest. The tax applies to a recipient of a covered gift or bequest only to the extent that the total value of covered gifts and bequests received by such recipient during a calendar year exceeds the annual gift tax exclusion amount for that calendar year, and there is a credit for the amount of any gift or estate tax paid to a foreign country with respect to such covered gift or bequest.

If the covered gift or bequest is made to a domestic trust, the tax applies as if the trust were a U.S. citizen, and the trust must pay the tax. If the covered gift or bequest is made to a foreign trust, the tax applies to any distribution attributable to the covered gift or bequest to a U.S. citizen or resident, in the same manner as if the distribution were a covered gift or bequest. The recipient may deduct the amount of tax for income tax purposes to the extent the tax is imposed on any portion of the distribution that is included in the recipient's gross income. For purposes of these rules, a foreign trust may elect to be treated as a domestic trust.

Effective Date of New Regime

The Act applies to individuals whose expatriation date is on or after the date of enactment. The prior expatriation regime under I.R.C. § 877 does not apply to a covered expatriate whose expatriation occurs on or after the date of enactment. The provision relating to covered gifts and bequests is effective for gifts and bequests made on or after the date of enactment by expatriates whose expatriation date is on or after the date of enactment. The information reporting requirements under the current regime will continue to apply to covered expatriates.

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We would be pleased to answer any questions you might have regarding the Act.

Stephanie E. Heilborn
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⁸ There are exceptions for (i) any property reported as a taxable gift by the covered expatriate, (ii) any property included in the U.S. gross estate of the covered expatriate, and (iii) any property with respect to which a marital or charitable deduction would be allowed.