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Tax Changes for Individual Expatriates

The American Jobs Creation Act of 2004

Section 804 of the American Jobs Creation Act of 2004 (the "*Act*")[1] strengthens the US federal income and transfer tax rules applicable to individuals who relinquish citizenship or terminate long-term residency (an "expatriate"). The new rules apply to individuals who expatriate after June 3, 2004.

This publication summarizes the pre-Act rules applicable to expatriates, including the alternative tax regime applicable for the first ten years following expatriation of any individual who was determined to have expatriated for the purpose of tax avoidance (a "*Tax-Avoidance Expatriate*"), and notes the changes made by the Act.[2]

Pre-Act Rules

- *Income Tax for Citizens and Residents*. Generally, US citizens and residents are subject to US federal income tax ("income tax") on their worldwide income.
- *Income Tax for Expatriates*. Subject to certain exceptions, an expatriate is subject to income tax to the same extent as a non-resident alien. In general, income tax is imposed only on: (i) income that is effectively connected with the conduct of a US trade or business, which is taxed at the same rate as a US citizen or resident; and (ii) US source passive income, which is subject to a 30% withholding tax, unless a lower treaty rate applies. However, for Tax-Avoidance Expatriates, US source income has a broader scope and includes (i) capital gains on the sale or exchange of property located in the US, other than stock or debt obligations; (ii) capital gains on the sale or exchange of stock of a US corporation and debt obligations of US persons; and (iii) income or gain derived from stock in a foreign corporation, if the expatriate owned, directly, indirectly or constructively, more than 50% of the vote or value of the stock of such corporation at any time during the two-year period preceding the date of expatriation.
- *Income Tax for Tax-Avoidance Expatriates*. For ten years following expatriation, a Tax-Avoidance Expatriate is subject to the higher of: (i) the income tax applicable to a non-resident alien and (ii) the income tax due on (a) income which is effectively connected with the conduct of a US trade or business, plus (b) US source passive income, each taxed at the rates applicable to US citizens or residents.
- *Gift, Estate and Generation-Skipping Transfer Taxes for Citizens and Residents*. Generally, US citizens and residents are subject to US federal transfer taxes ("transfer taxes") on their worldwide assets.
- *Gift, Estate and Generation-Skipping Taxes for Expatriates*. Generally, an expatriate is subject to transfer taxes to the same extent as a non-domiciliary alien. That is, transfer tax is imposed only on transfers of US situs assets.
- *Gift Tax for Tax-Avoidance Expatriates*. For ten years following expatriation, a Tax-Avoidance Expatriate is subject to US federal gift tax to the same extent as a non-domiciliary alien, except that a Tax-Avoidance Expatriate will also be liable for US federal gift tax on transfers of US situs intangible property, such as US corporate stock. However, a Tax-Avoidance Expatriate may transfer non-US situs property, both tangible and intangible (such as stock in a foreign corporation) free of US federal gift tax.
- *Estate Tax for Tax-Avoidance Expatriates*. For ten years following expatriation, a Tax-Avoidance Expatriate is subject to US federal estate tax to the same extent as a non-domiciliary alien, except that a Tax-Avoidance Expatriate will also be required to include in his or her gross estate a *pro rata* portion of the fair market value of stock in a foreign corporation owned at death (determined by comparing the fair market value of the US situs assets of the corporation to the total value of the corporation's assets), if the expatriate: (i) owned,

directly or indirectly, 10% or more of the voting power of the corporation; and (ii) owned, directly, indirectly or constructively, at least 50% of either the voting power or value of the stock of such corporation.

- *Presumption of Tax Avoidance*. With few exceptions, prior to the Act, a US citizen who renounced his or her citizenship (or a lawful permanent resident who relinquished his or her green card after holding it for eight of the previous 15 years) was presumed to be a Tax-Avoidance Expatriate if he or she met certain income tax or net worth thresholds.

- *Income Tax and Net Worth Thresholds*. Prior to the Act, an expatriate was presumed to be a Tax-Avoidance Expatriate if: (i) the average annual net income tax of such individual for a period of five taxable years ending before the date of the expatriation is greater than $124,000; or (ii) the net worth of the individual as of such date was $622,000 or more. An individual whose income tax or net worth exceeded these thresholds could request a ruling from the Internal Revenue Service (the "*IRS*") that his or her expatriation did not have a tax avoidance-motive.

- *Exceptions to Income Tax and Net Worth Thresholds*. An expatriate whose income tax or net worth exceeded these thresholds would not be presumed to be a Tax-Avoidance Expatriate if: (i) the individual became at birth a citizen of the US and a citizen of another country and continues to be a citizen of such other country; (ii) within a reasonable period after expatriation, the individual became a citizen of the country in which the individual, the individual's spouse, or either of the individual's parents was born; (iii) the individual was present in the US for 30 or fewer days in each year in the ten-year period ending on the date of expatriation; or (iv) the individual relinquished his US citizenship before attaining the age of 18½. However, to qualify for one of these exceptions, the individual was required, within one year from the date of expatriation, to submit a ruling request to the IRS for a determination as to whether such loss had the avoidance of tax as a principal purpose.

- *Information Reporting*. A one-time statement is required of expatriates to disclose certain information about assets held at the time of expatriation.

- *Bar Against Re-entry for Certain Expatriates*. Pursuant to a 1996 change to US immigration law (known as the "Reed Amendment"), any alien who is a former citizen of the US, who officially renounces US citizenship and who is determined by the US Attorney General to have renounced citizenship for the purpose of avoiding taxation will be denied re-entry to the US. Designation for income tax purposes as a Tax-Avoidance Expatriate does *not* automatically trigger this provision. The Attorney General must make a separate and independent determination of tax avoidance. However, the Attorney General has limited access to tax returns to make such determination. In fact, as of February 2003, we understand that not a single expatriate had been denied re-entry under this provision.

New Rules

- *Income Tax and Net Worth Thresholds*. The income threshold is unchanged by the Act. However, the Act increases the net worth threshold to $2 million.

- *Presumption of Tax Avoidance*. In addition to the income tax and net worth thresholds, under the Act, an individual is presumed to be a Tax-Avoidance Expatriate if the individual fails to certify under penalty of perjury his or her compliance with US tax laws for the previous five years.

- *Subjective Test Repealed*. Individuals who do not meet the income tax or net worth thresholds (or having met one of the thresholds but qualified for an exception) are no longer subject to the alternate tax regime based on a subjective finding of tax avoidance.

- *Gift Tax for Tax-Avoidance Expatriates*. The Act eliminates the blanket exception for gifts of stock in certain foreign corporations. For ten years following expatriation, a Tax-Avoidance Expatriate will be subject to US federal gift tax on a *pro rata* portion of the fair market value of stock in a foreign corporation transferred by gift (determined by comparing the fair market value of the US situs assets of the corporation to the total value of the corporation's assets) if the expatriate: (i) owned, directly or indirectly, 10% or more of the voting power of the corporation; and (ii) owned, directly, indirectly or constructively, at least 50% of either the voting power or value of the stock of such corporation.

- *Exceptions to Presumption of Tax Avoidance*. The Act eliminates the exception for an individual who, within a reasonable period after expatriation, becomes a citizen of the country in which the individual, the individual's spouse, or either of the individual's parents was born and the exception for an individual who is present in the US for 30 or fewer days in each year in the ten-year period ending on the date of expatriation. The dual

citizenship exception remains, with the added requirement that the individual has had no substantial contacts with the US (never a resident of the US, never held a US passport, not present in the US for more than 30 days during any of the ten years preceding expatriation). The exception for minors remains, with the added requirements that the individual became at birth a citizen of the US, neither parent of such individual was a citizen of the US at the time of such individual's birth, and the individual was not present in the US for more than 30 days during any of the ten years preceding expatriation.

- *Annual Information Reporting*. The Act requires a Tax-Avoidance Expatriate to file an annual return for each of the ten years following expatriation, even if no US federal income tax is due. The annual return requires disclosure of certain information, including the permanent home of the individual, the individual's country of residence, the number of days the individual was present in the US, and details about the individual's income and assets, including information relating to foreign securities. Failure to file a properly completed return may result in a penalty of $5,000.

- *Notice of Expatriation*. Under the Act, an individual must give notice to the Secretary of State (in the case of a former US citizen) or the Secretary of Homeland Security (in the case of a former long-term resident) of his or her expatriation and provide a statement containing certain personal and financial information. Until such notice is rendered, individuals who expatriate continue to be taxed as US citizens or residents.

- *Penalties for Prolonged Visits to the US*. Under the Act, if a Tax-Avoidance Expatriate is present in the US for more than 30 days in any year during the first ten years following the date of expatriation, the individual is subject to: (i) US income tax on his or her aggregate worldwide income; (ii) US gift tax on the transfer of any of the expatriate's worldwide assets by gift; and (iii) US estate tax on his or her worldwide assets, if he or she dies during that year. The present-law exceptions from being treated as present in the US for residency purposes (i.e., being in the US as a teacher, trainee, student, professional athlete or foreign government-related individual, as a commuter from Canada or Mexico, as a crew member temporarily in the US or being in the US because of a medical condition that arose while in the US or because of transit between two foreign points) generally do not apply for this purpose.

- *Exception to the 30-Day Rule*. Up to 30 days of presence in the US on account of a Tax-Avoidance Expatriate performing services for an unrelated employer may be disregarded if the individual has significant ties to a country other than the US (i.e., the individual, his or her spouse, or his or her parents were born in the foreign country or the individual becomes fully liable for income tax in a foreign country) or the individual has a minimal prior physical presence in the US (i.e., the individual was physically present in the US for no more than 30 days during each year in the ten-year period ending on the date of expatriation, excluding any day the individual was in the US as a teacher, trainee, student, professional athlete or foreign government-related individual or because of a medical condition that arose while the individual was in the US).

- *Bar Against Re-entry for Certain Expatriates*. The Senate bill would have repealed the Reed Amendment and instead would have denied a former citizen re-entry into the United States if the individual was determined not to be in compliance with his or her tax obligations (regardless of the subjective motive for expatriating) and would have permitted the Attorney General to request certain information about the taxpayer from the IRS to make such determination. The final version of the Act, however, did not include either of these amendments. Therefore, the Reed Amendment remains on the books in its current form.

- *Interim Expatriates*. The status of individuals who expatriated after June 3, 2004 and prior to enactment of the Act ("Interim Expatriates") is unclear. Due to the retroactive effective date of the Act, Interim Expatriates are required to comply with the new rules, even if, at the time of expatriation, they satisfied the pre-Act rules. As an example, an Interim Expatriate whose income tax and net worth did not exceed the thresholds under the pre-Act rules may still be subject to the alternative tax regime for failing to file the financial statement provided for in the Act. We understand that the IRS is aware of these problems and is drafting guidance to address the issues.

ENDNOTES

[1] For the text of the Act, H.R. 4520, 108th Cong. (2004), as approved by Congress and signed by the President on October 22, 2004, *see* http://frwebgate.access.gpo.gov/cgibin/getpage.cgi?dbname=2004_record&page=H8411&position=all.

[2] The provisions of the Act reflect recommendations contained in Joint Committee on Taxation, *Review of the Present-Law Tax and Immigration Treatment of Relinquishment of Citizenship and Termination of Long-Term Residency* (JCS-2-03), February 2003. Readers should note that the Senate version of what became Section 804 would have replaced the alternative tax regime with an "exit tax" on worldwide assets. This version, which was originally proposed in 1995 during the Clinton Administration, was not enacted.

This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations, if desired. For more information on the topics covered in this issue, please contact:

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