



US TAX ALERT

November 2008 – Issue 4-08 – Amended February 2009

US TAX ALERT is a commentary on topics of special interest – usually topics relating to recent changes in the law, administrative practices or interpretations by taxation authorities. Professional advice should be obtained before acting on any of this information.

US EXPATRIATION

The United States has had expatriation rules for many years which apply extended taxes to individuals who give up their US citizenship or (as long term residents of the United States) surrender their green cards (permanent resident visa). The rules changed dramatically on June 17, 2008 under what is known as the HEART legislation. This **US TAX ALERT** will deal mostly with the new rules for expatriating individuals.

The June 2008 Legislation

If a US citizen or green card holder gave up their status before June 17, 2008, these taxpayers are required to file US tax returns for a further ten years at tax rates higher than normal under what is sometimes described as the *alternative tax regime*. These same rules (subject to any exemptions) continue to apply to such individuals and they are not affected by the HEART Legislation. The new rules start on June 17, 2008.

Under the new legislation, the filing of 10 years of tax returns will be discontinued but instead *covered expatriates* will be required to pay tax on capital gains (in excess of \$600,000) on the deemed disposition of worldwide assets at the time of expatriation. The old law is under Section 877 of the Internal Revenue Code (IRC) and the new law is under Section 877A. A *covered expatriate* under the new law only includes US citizens and green card holders. If suitable security is provided an election can be made to defer the tax until the asset is sold or until death.

US Long-Term US Resident Green Card Holders

The definition of US long-term resident (which essentially makes a taxpayer's obligations the same as a US citizen) is a person who is not a US citizen but who held a green card for all or part of any eight years in the previous fifteen calendar years and meets any *one* of the following tests at the time of expatriation:

- ◆ The individual's net worth is at least US \$2,000,000 including interests in certain trusts.
- ◆ The individuals average annual net income tax liability for the five prior years exceeds US \$139,000 (inflation adjusted).
- ◆ The individual fails to *certify* meeting all federal tax obligations for the five previous years.

The new tax legislation (but not the old law) does not apply the extended taxes to persons meeting the above tests if they are dual citizens at birth and continue to be dual citizens of both countries since the date of expatriation and meet further additional tests as follows:

- ◆ Taxed as residents of the other country at the date of expatriation.
- ◆ Have not been US income tax residents for more than ten of the last fifteen years.

An exception to the extended taxes (under the new rules only) is also made for persons who expatriate before age 18 ½ providing they have not been a US tax resident for more than ten taxable years before relinquishment. This basically allows young adults six months after they reach the age of majority to make up their mind if they want to give up their permanent ties as US citizens.

Computation of Tax on Capital Gains

Tax is computed on capital gains as if worldwide assets were sold at fair market value the day before expatriation. Capital losses can be deducted but the US *wash sale* rules for purchases and sales within 30 days do not apply. A basic exemption of US \$600,000 of capital gains is provided. Capital gains tax can be deferred on any asset until it is sold or until death if security is provided.

For green card holders, the cost base of assets for calculation of the capital gain is no less than their fair market value at the time of immigration to the USA. This rule does not apply for most other provisions to the Internal Revenue Code which only recognizes the historical cost of assets. In many respects, the concept of a deemed disposition under the HEART legislation is similar to Canada's deemed disposition rules on emigration.

Deferred compensation and tax deferred retirement accounts are not subject to the immediate capital gains tax but covered expatriates are deemed to have received his or her entire interest in IRA and certain other tax deferred accounts on the day before expatriation. Special rules apply including a 30% tax on the value of the plans the day before expatriation will apply. The 10% on early distribution will not apply. There are detailed rules for non grantor trusts which will not be covered in this **US TAX ALERT**.

New Transfer Tax - Gifts and Bequests

New Section 2801 imposes a special transfer tax on gifts and bequests made by the expatriate at the highest estate or gift tax rates (for the rest of their life and on death) to a US citizen, US trusts or US resident at the highest estate or gift tax rates. The tax is paid by the recipient. The gift and bequests extended tax does not apply unless the expatriate meets either the \$139,000 income threshold test or the \$2 million asset test based on values at the time the gift is made or on the value of estate assets immediately before death. The US recipient pays the tax.

The \$12,000 gift tax exemption is available as is the estate tax exemption on transfers to a spouse who is a US citizen. The transfer tax does not apply to gifts and bequests subject to US estate tax.

Filing Compliance

Taxpayers wishing to expatriate must notify the State Department if they want to revoke their US citizenship or the Secretary of Homeland Security if they wish to terminate their green card. Under the old rules, they were also required to notify the IRS on Form 8854 but no time limit existed to file the form. Expatriation did not become effective until it was filed. Under the new rules, there is no

requirement to notify the IRS before the expatriation is official to establish expatriation for tax purposes but information reporting is still required on Form 8854 on a one time only basis. There are severe penalties for not filing Form 8854. Under the old rules, Form 8854 had to be filed for ten years but this is no longer the case.

The New Law Can Be Better

The new law is less onerous to taxpayers who meet (one or more) of the following tests.

- ◆ Taxpayers holding largely unappreciated assets (with less than \$600,000 of gains) at the time of expatriation.
- ◆ Taxpayers who wish to visit the US for up to 120 days per year (as is allowed under the new law) instead of the 30 days after expatriation allowed under the old rules.
- ◆ Taxpayers who were citizens of both countries from birth.
- ◆ Taxpayers who have no family beneficiaries remaining in the United States.

In some ways, the new rules are much more flexible than the old ones. The \$600,000 exemption will avoid the tax except for some high net worth individuals. The exemption for people under 18½ is more generous. Green card holders would be wise to give up their green card before year eight to avoid long term resident US tax repercussions. On the other hand, US citizens should not expatriate lightly because some may wish to return to the US for family, employment or other reasons.

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