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The Tax Consequences of Expatriating from the United States

Patrick J. McCormick*

Abstract: Familiarity with the tax consequences of leaving the United States is important for immigration advisors, particularly for those working with individuals either renouncing citizenship or abandoning green card holder status. This article details the U.S. tax considerations in the expatriation context—first discussing the tax benefits of expatriation, then exploring the special tax rules applicable upon departure. Options to avoid tax consequences on expatriation are considered, discussing benefits and pitfalls of these options.

The inaugural issue of the *AILA Law Journal* included an excellent article by Kehrela Hodkinson exploring the non-tax reasons a U.S. citizen might renounce their citizenship. As Hodkinson noted explicitly, the article excluded an analysis of the tax rules associated with expatriation; as she stated, however, "[T]ax and renunciation go hand in glove, and compliance with the set of regulations governing one but not the other does not make for a complete exit from U.S. regulatory requirements."[1]

This article provides an overview of the tax considerations for expatriates. For tax purposes, expatriates are either U.S. citizens or long-term U.S. green card holders. It provides background information on income and transfer tax differences between U.S.-based taxpayers and nonresidents, illustrating the tax benefits of expatriation. The article also details the tax considerations relevant when a U.S. taxpayer expatriates, focusing on "covered expatriates"—those for whom special tax rules apply. It then discusses the tax ramifications borne by covered expatriates (requiring tax recognition of built-in gain on worldwide assets at expatriation) and rules applicable to future beneficiaries of the covered expatriate. Finally, the article considers strategies for avoiding covered expatriate status and timing considerations associated with avoidance techniques.

U.S. Tax Background

Taxation of U.S. Individuals

U.S. citizens and tax residents are taxable on their worldwide income, no matter where they reside or how the income is generated (*i.e.*, even if all activities associated with generating the income occurred outside the United States).[2] When compared to tax residency, citizenship determinations are

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usually more straightforward—individuals born citizens keep that status until they (formally) renounce it, even if they live overseas full time.

Statutorily, U.S. income tax residency includes two general non-elective categories (for income tax purposes): (1) those lawfully admitted for permanent residence in the United States, and (2) those meeting substantial presence standards;[3] only the former are subject to covered expatriate status.[4] Individuals lawfully admitted for permanent residence are U.S. green card holders; importantly, green card holders, like citizens, are taxed on worldwide income irrespective of their actual physical presence, although, unlike for citizens, this result can be modified by income tax treaty "tiebreaker" provisions.[5]

Income tax treaties—agreements entered between two countries to facilitate economic activity between the countries' residents—allow green card holders to be reclassified as U.S. nonresidents. Reclassification is permitted if the relevant individual is classified as both a tax resident of the United States and a treaty party country, and if the individual's connections to the other country are closer than to the United States (normally focusing on the person's "center of vital interests").[6] Critically, a long-term green card holder who reclassifies after years of U.S. presence risks classification as a covered expatriate by virtue of a reclassification election.[7]

Transfer taxes—estate and gift taxes—are also assessed by the United States. American citizens and domiciliaries (U.S. residents with no present intention of leaving the country) are subject to transfer taxes on gratuitous transfers of worldwide assets (gift taxes for transfers made during their lifetime, and estate taxes for transfers made at death).[8] For transfer tax purposes, an individual is treated as a U.S. domiciliary when he or she is a U.S. resident and has no present intention of leaving the United States.[9]

Citizens and domiciliaries receive a lifetime exclusion for estate and gift tax purposes, protecting a set amount of transfers from U.S. tax. For 2020, this exclusion amount is $11,580,000.[10] Exclusion amounts can be combined for married couples through portability, allowing a decedent's executor to transfer any unused exclusion amount to the surviving spouse. Importantly, the current exclusion amount is set to be halved in 2026, and further variance/revision of the exclusion amount (either upward or downward) is entirely plausible.[11]

Taxation of Nonresident Aliens

Nonresidents are taxed by the United States on income connected to the United States, either by virtue of being: (1) effectively connected with the nonresident's conduct of a U.S. trade or business, or (2) U.S.-sourced income not connected with a nonresident's U.S. trade or business and not capital gains income (fixed or determinable annual or periodic income or "FDAP Income").

Case law dictates that a U.S. trade or business exists where profit-oriented activities that are regular, substantial, and continuous, are carried on in the

United States.[12] Effectively connected income (ECI) is taxable in the United States at graduated rates. Income tax treaties (slightly) elevate the statutory standard, typically providing that residents of a treaty party country can instead elect to use a "business profits attributable to a United States permanent establishment" threshold.

Nonresidents are generally not subject to capital gains tax by the United States for gains not effectively connected with a U.S. trade or business attributable to a permanent establishment. A nonresident disposing of a U.S. real property interest, however, is subject to tax on any gain from the disposition, as this income is statutorily classified as effectively connected income.[13]

FDAP income includes dividends, rent, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, or other fixed or determinable annual or periodic gains, profits, and income sourced to the United States.[14] Unlike most other types of income (including a nonresident alien's ECI), FDAP income is taxed at a flat 30 percent rate, with no deductions permitted and tax primarily collected through payor withholdings.

Nonresidents are subject to U.S. transfer tax on a limited scope of assets but are given only a fraction of the exemption amounts available to U.S. citizens and domiciliaries. Estate tax is assessable on all property (whether tangible or intangible) sitused to the United States, subject to exceptions.[15] For estate tax, nonresidents receive a $60,000 estate tax exclusion with a maximum 40 percent rate of tax applicable.[16] Gift tax is assessed on lifetime gratuitous transfers of tangible property within the United States by nonresidents.[17] Nonresident individuals receive no specific lifetime exclusion, though they are permitted to utilize annual gift exclusions of $15,000 per donee (an exception also available for U.S. taxpayers).[18]

Classification Considerations/Expatriation Motivations

U.S. tax requirements for nonresidents are significantly more limited than for U.S.-based taxpayers, though U.S. tax results for nonresidents are often more punitive where tax is assessed (particularly in the transfer tax realm). Individuals almost always prefer classification as a nonresident for income tax purposes, given that it both generally removes foreign-sourced income from U.S. tax and also precludes taxation of specified U.S.-sourced income items such as certain U.S.-sourced capital gains.

Determinations as to ideal classification for transfer tax purposes are more fact specific. U.S. citizens and domiciliaries are subject to tax on worldwide assets but receive significant lifetime exemptions. Nonresidents are subject to a narrower transfer tax scope but receive a comparatively miniscule exclusion. Critically, however, nonresidents typically can avoid U.S. transfer tax exposure with proper tax planning (which is usually focused on not having the nonresident own assets in their individual capacity). Nonresidents aware of the U.S.

transfer tax rules thus are not overwhelmingly concerned with transfer taxes, and nonresident status is clearly preferable for certain taxpayers—those of current significant net worth or those concerned that future events (whether accretions to their net worth or reductions in U.S. exclusion amounts) will leave them subject to transfer tax as citizens or domiciliaries.

Expatriation and Exit Tax

Once an individual has decided to forfeit their American status, the U.S. tax consequence of expatriation is exposure to the "exit tax"—a mark-to-market regime designed to capture (and tax) gains that have accrued during the individual's period as a U.S. taxpayer. Initial analysis of whether an individual could be subject to the exit tax focuses on whether the individual is a covered expatriate; only covered expatriates are subject to the imposition of exit tax. An expatriate is defined by the Internal Revenue Code as: (1) a U.S. citizen relinquishing their citizenship, and (2) a long-term U.S. resident who ceases to be a lawful permanent resident.[19] A long-term resident is a noncitizen individual who is a green card holder for at least 8 out of the past 15 tax years.[20]

All renouncing U.S. citizens are classified as expatriates; however, shorter-term green card holders (*i.e.*, those who have not held their green card for 8 years) avoid expatriate classification. This is an important consideration for green card holders not anticipating a lifelong stay in the United States—renunciation of a green card prior to meeting the "8 out of 15 tax years" standard allows avoidance of any exit tax or covered expatriate considerations.

A covered expatriate is any expatriate (under the definition above) who meets one of three tests: (1) the individual's average net income tax for the period of five tax years ending before the cessation date is greater than $171,000 for 2019 (the "tax liability test"), (2) the net worth of the individual as of the cessation date is $2,000,000 or more (the "net worth test"), or (3) the individual fails to certify under penalty of perjury that U.S. tax requirements have been met for the five preceding tax years (the "certification test").[21]

An expatriate meets the tax liability test if his or her average net income tax liability for the five years pre-expatriation exceeds $171,000 for 2020.[22] Individuals filing joint income tax returns must base calculations on the net income tax reflected on the joint return. Certain credits are available for purposes of determining the net income tax liability; foreign tax credits are an often-beneficial credit taken into account.[23]

Most often, individuals will be classified as covered expatriates based on the net worth test, met when the expatriating individual's net worth (as of their expatriation date) exceeds $2,000,000.[24] For valuation purposes, asset values are generally determined under gift tax principles (with the value of property generally being the price a willing buyer and seller would agree upon). A taxpayer must use good faith estimates as to asset values; however, formal appraisals are not required. Liabilities (such as mortgages) are deducted for purposes of the net worth test. An individual's interest in a trust is also included for net worth purposes; a two-step process is undertaken to determine the value of the trust attributable to the expatriate. First, interests in trusts are allocated proportionately among all beneficiaries by considering all facts and circumstances; interests allocable to the expatriate are then valued.

Expatriates are classified as covered expatriates if they cannot certify compliance with the Internal Revenue Service (IRS) requirements for the five years prior to expatriation.[25] This requirement (at least hypothetically) can cause an individual without significant net income or net worth to be subject to the exit tax. Cognizance of the certification test, however, usually leads to avoidance of failing it: even individuals who historically have been noncompliant with U.S. tax obligations (most often, those who have lived overseas for an extended period pre-exit) have straightforward options to cure retroactive failures.[26] The required certification is made by filing Form 8854.

An individual meeting either the tax liability test or the net asset test can avoid classification as a covered expatriate by meeting one of two statutory exceptions. These exceptions apply to an individual who: (1) became at birth a dual citizen of the United States and another country, remains a citizen of that other country as of his or her expatriation date, and did not reside in the United States for more than 10 of the past 15 tax years (ending with the tax year during which expatriation occurs); or (2) relinquishes U.S. citizenship before age 18½ and did not reside in the United States for more than 10 taxable years before the date of relinquishment.

Exit Tax: The "Mark-to-Market" Regime

Under exit tax principles, an expatriate is treated as selling at fair market value their worldwide holdings (subject to a few exceptions), creating a fictional recognition event for built-in gain (referenced as the "mark-to-market" rules). Gain is reported on the individual's Form 1040 (as the recognition occurs the day before expatriation, *i.e.*, while they are still subject to worldwide taxation by the United States).

Mark-to-Market Mechanics

Fair market value and basis of assets must be determined (with taxable gain being the excess of the fair market value after subtraction of basis). A covered expatriate is treated as owning any property that would be treated as part of their estate and is also considered to be the owner of any beneficial interests in trusts. Fair market value of assets held is also determined under general estate tax guidelines.[27]

An individual's basis generally follows normal principles for determination of basis, with one important deviation: the basis of long-term residents in their assets is the fair market value of those assets on the date their residence in the United States began.[28] This can be an important benefit for assets that appreciated in value prior to the expatriate becoming a U.S. resident.

Once the fair market value and basis of each asset has been ascertained, gain (and loss) is aggregated to determine the amount of gain recognition under the mark-to-market regime. Some relief is available—the first $737,000 (for 2020; this number is also adjusted annually for inflation) of gain under mark-to-market rules is not subject to tax.[29] After this allocation, gains (and losses) are reported on the Form 1040 (and applicable schedules) depending upon the character of each asset.[30] A deferral for payment of the exit tax is available by election, and is made on an asset-by-asset basis. Where the election is made, payment of tax is not required until each asset for which an election was made is sold.[31]

The mark-to-market regime is inapplicable to three types of assets: (1) deferred compensation items, (2) specified tax-deferred accounts, and (3) interests in non-grantor trusts.[32] For eligible deferred compensation items, the payor must withhold a tax of 30 percent on any taxable payment to a covered expatriate; for ineligible deferred compensation items, an expatriate is subject to tax as if it were received the day prior to expatriation. Tax-deferred accounts are treated as having their entire balance distributed to the expatriate on the day before his or her expatriation date. For distributions of property from a non-grantor trust to a covered expatriate, the trustee of the trust withholds 30 percent of the taxable portion of the subsequent distribution.

Post-Expatriation Ramifications

Most would assume that, once expatriation has occurred, U.S. tax implications finally and mercifully cease; however, this belief (at least for covered expatriates) can be mistaken. Special rules have been enacted for gifts or bequests from covered expatriates to U.S. beneficiaries; these transfers are statutorily subject to tax at the highest applicable rate for gifts/bequests (currently 40 percent).[33] Tax owed is paid by the recipient of the gift or bequest (a departure from the normal U.S. tax rules, where transfer taxes are paid by the transferor).[34]

For this inheritance tax to apply, transfers must be made to U.S. citizens or residents; where transfers are made to nonresidents, the inheritance tax is inapplicable. For these purposes, however, a gift/bequest made indirectly by a covered expatriate to a U.S. beneficiary by using a foreign intermediary (*i.e.*, covered expatriate making a gift to a nonresident, who then gifts the asset to the U.S. person) is a covered gift/bequest.

Critically, satisfaction of requirements for the inheritance tax is deferred until the IRS issues guidance on the tax; proposed regulations regarding gifts and bequests from covered expatriates were issued in 2015, but deferment of obligations continues at present.[35] Form 708 is to be used to report such gifts or bequests, but has yet to be issued; the IRS has provided that Form 708 will be issued when the Sec. 2801 regulations are finalized, with time then provided to taxpayers to meet requirements.[36]

Planning for Expatriation/General Expatriate Tax Considerations

Individuals subject to the exit tax can face drastic tax ramifications on (and after) expatriation; however, they can take steps prior to expatriation to either avoid covered expatriate status or, where avoidance is not possible, mitigate its tax impact.

In planning for the tax consequences of expatriation, focus is primarily on gifting strategies using the individual's lifetime exclusion amount (currently $11.58 million) prior to his or her expatriation. Individuals who would be classified as covered expatriates under the net worth test can make gifts while still classified as U.S. citizens/domiciliaries to reduce net worth. Assessment of whether an individual meets the net asset test is based on net worth as of the date of relinquishment of U.S. citizenship/green card status; the expatriate's net worth can be lowered prior to this date (particularly when factoring in that the first $737,000 of gain generated by the mark-to-market approach is exempt from tax).

Mark-to-market rules (and the exit tax rules generally) do not allow an expatriating individual to automatically apply their existing lifetime exclusion to shield gain on expatriation; thus, proactive exhaustion of this amount provides a major tax benefit. Care must be undertaken in a number of respects, however. First, transfers must be made in the year prior to expatriation; gifts in the year of expatriation cannot be offset by the lifetime exclusion amount.[37] Often, this creates a delay in expatriation so that, if needed, proper tax planning can occur.

Any exit tax planning should ensure that gifts made do not leave the expatriate with insufficient net worth to live their desired lifestyle moving forward (understandably, the expatriate's age is often a relevant factor in determining appropriate amounts to gift). Given the scope of what is included as assets for net worth purposes—any assets for which the expatriate would have gift tax obligations in the United States if the transfer were made while still a U.S. taxpayer—transfers can be structured to avoid inclusion of assets for net worth test purposes while permitting benefit from the assets moving forward.

Outside the exit tax, risk that future gifts or bequests to U.S. beneficiaries could subject those beneficiaries to inheritance taxes is disconcerting to expatriates. As provided, the inheritance tax is currently not enforced, but the IRS has left open the possibility that it will be in the future, and has done nothing to preclude retroactive application of requirements. Risk of a prospective inheritance tax can be the primary reason to avoid covered expatriate status, particularly for individuals who, under the mark-to-market regime, would face little or no exit tax on expatriation.

Conclusion

As immigration practitioners are well aware, a multitude of non-tax (and non-financial) factors can motivate a U.S.-based individual to cease their U.S. residency. Cognizance of tax repercussions is needed by any advisor working with an expatriating individual. With proper design, immigration/residency goals can be met while shielding the expatriates—or their future heirs—from unexpected tax impact.

Notes

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1. Kehrela Hodkinson, "Renunciation of U.S. Citizenship: Why Would a Client 'Give It All Up'?" 1 AILA Law Journal, 71, 71 (April 2019).

2. 26 U.S.C. § 1.

3. Substantial presence requirements are met when an individual spends at least 31 days in the current year in the United States, and the sum of days in the previous three years, after the use of applicable multipliers, exceeds 183.

4. 26 U.S.C. § 7701(b)(1)(A).

5. 26 U.S.C. § 7701(b)(1)(A)(i).

6. *See* United States-United Kingdom Income Tax Treaty, Art. 4(4).

7. Reclassification under income tax treaties, which requires the reclassifying green card holder to have a stronger level of connection with another country, poses assorted immigration-focused questions outside the focus of this article.

8. 26 U.S.C. § 2001; 26 U.S.C. § 2501.

9. *See* 26 C.F.R. § 20.0-1(b); 26 C.F.R. § 25.2501-1(b).

10. 26 U.S.C. § 2010.

11. For contextual purposes, the estate tax exclusion was $2,000,000 in 2008, and $1,000,000 in 2001. *See* "Federal Estate, Gift and GST Tax Rates and Exemptions," McDermott Will and Emery.

12. *See* U.S. v. Balanovski, 236 F.2d 298 (2d Cir. 1956); U.S. v. Northumberland Insurance Company, 521 F. Supp. 70 (D.N.J. 1981).

13. 26 U.S.C. § 897(a).

14. *See* 26 U.S.C. § 1441(b).

15. 26 C.F.R. § 20.2104-1(a)(1). Exceptions are granted for life insurance proceeds, bank accounts not used in connection with a U.S. trade or business, and stock or securities generating portfolio interest.

16. 26 U.S.C. § 2001(c).

17. 26 C.F.R. § 25.2511-3.

18. 26 U.S.C. § 2503(b).

19. 26 U.S.C. § 877A(g)(2).

20. 26 U.S.C. § 877A(g)(3)(B).

21. 26 U.S.C. § 877(a)(2).

22. 26 U.S.C. § 877(a)(2)(A). *See also* Revenue Procedure 2016-55. The $171,000 amount is indexed annually for inflation.

23. *See* 26 U.S.C. § 27.

24. 26 U.S.C. § 877(a)(2)(B).

25. 26 U.S.C. § 877(a)(2)(C).

26. For citizens/green card holders residing overseas, an especially appealing option is the Streamlined Filing Offshore Procedures, which provide a penalty-free method to come into compliance with U.S. tax obligations.

27. Notice 2009-85.

28. 26 U.S.C. § 877A(h)(2).

29. 26 U.S.C. § 877A(a)(3).

30. Notice 2009-85.

31. 26 U.S.C. § 877A(b)(1).

32. 26 U.S.C. § 877A(d)-(f).

33. 26 U.S.C. § 2801(a).

34. 26 U.S.C. § 2801(b).

35. *See* Notice 2009-85; *Internal Revenue Bulletin* 2015-39.

36. *See* Announcement 2009-58.

37. *See* 26 U.S.C. § 2505.