Expatriation: How to Leave the U.S. Tax System Forever

Think you pay too much in taxes? Get better tax advice. Hire a tax lawyer and undertake the planning necessary to minimize U.S. taxes or take the ultimate step. Leave. Renounce your citizenship and escape the U.S. tax system forever.

U.S. citizens and residents are subject to U.S. income taxation on worldwide income while alive and subject to U.S. estate tax income on worldwide assets at death. In contrast, individuals who are neither citizens nor residents of the United States are only subject to U.S. income taxation on income from sources within the United States and U.S. estate taxation on assets physically present or deemed to be present in the United States. Leaving, however, comes at a cost. Since June 17, 2008, the United States has imposed an exit tax. The exit tax of IRC section 877A applies not only to U.S. citizens who renounce their citizenship, but also to individuals who have lawful permanent resident status for eight of the fifteen years prior to terminating residency.

The exit tax applies to U.S. persons whose net worth exceeds $2 million dollars (the "Net Worth Test") or whose average annual net income tax liability for the five years prior to the year of expatriation exceeds a base amount of $124,000 as adjusted for inflation ($157,000 for individuals expatriating in 2014) (the "Tax Liability Test"). Any U.S. citizen or long-term resident who satisfies the Net Worth Test or the Tax Liability Test is characterized as a "covered expatriate" and subject to the exit tax. However, the converse is not necessarily true. That is, a taxpayer who does not satisfy either of the Tests is not necessarily exempt from the exit tax.

In order to avoid the exit tax, the taxpayer who is expatriating must also be U.S. tax compliant: that is, all U.S. tax returns (including employment, gift tax, and information returns) must have been filed by the individual for each of the five taxable years preceding the taxable year in which expatriation occurs and all relevant tax liabilities, interest, and penalties must have been paid.

The obvious planning opportunity to avoid status as a covered expatriate is to give assets away prior to expatriation so as to avoid the Net Worth Test. If the asset transfers reduce the taxpayer's net worth below the $2 million threshold, the exit tax may be avoided. (The taxpayer will also have to escape the Tax Liability Test in order to avoid status as a covered expatriate.) Gifts prior to expatriation will qualify for the $5 million gift tax exemption (inflation adjusted to $5,340,000 for gifts made in 2014). However, disclosure is required of any significant changes in assets or liabilities of the covered expatriate during the five year period prior to expatriation.

Generally, the exit tax is a tax on the unrealized income inherent in the covered expatriate's assets. Thus, assets the individual owns are deemed to have been sold on the date of expatriation. Retirement plan assets and other deferred compensation items are deemed to have been paid to the covered expatriate on the date of expatriation. A $600,000 exclusion is available to offset gain resulting from the deemed sale of the covered expatriate's assets. The exclusion is indexed for inflation and is currently

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$680,000 for taxpayers expatriating in 2014. Losses realized as a result of marking-to-market the covered expatriate's assets are applied to offset gains.

There are two opportunities to defer the exit tax. First, in the case of any asset subject to the mark-to-market regime gain recognition may be deferred until the asset is sold. Elective deferral is available on an asset-by-asset basis. The covered expatriate must waive any treaty benefits which would preclude assessment or collection of the exit tax, provide adequate security, enter into a tax deferral agreement with the Internal Revenue Service, and appoint a U.S. person to act as the covered expatriate's agent.

Deferral is also available with respect to certain deferred compensation items. In order to satisfy the requirements of the statute, the deferred compensation must be payable by a United States person or a person who elects to be treated as a United States person for purposes of the statute. The covered expatriate must notify the payor of the taxpayer's status as a covered expatriate and waive reduced withholding provided by any applicable tax treaty. As a result of the treaty waiver, payment of the deferred compensation to the covered expatriate will be subject to 30% withholding.

Individual retirement accounts and individual retirement annuities (other than simplified employee pension plans and simple retirement accounts), 529 plans, Coverdell education savings accounts, health savings accounts, and Archer medical savings accounts are not eligible for deferral. Early distribution taxes and penalties will not apply in computing the tax liability for tax-deferred accounts subject to the exit tax.

After expatriating, if the covered expatriate makes a gift or bequest to a United States citizen or resident a gift or estate tax will be imposed. The tax falls not on the covered expatriate but rather the U.S. citizen or resident receiving the gift or bequest from the covered expatriate. Because of the adverse gift and estate tax treatment imposed on U.S. situs assets when transferred by a nonresident alien while alive or at death, these assets should be transferred prior to expatriation.

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