Planning for Foreign Individuals with U.S. Activities Where Tax and Immigration Law Meet (and Sometimes Collide)

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Overview

- This program will introduce tax lawyers to key U.S. citizenship and immigration rules and how they interact, and sometimes, collide with tax rules that apply to U.S. citizens and residents (RAs) and nonresident aliens (NRAs)
- U.S. immigration law deals with individuals who come to or stay in the United States and what they can do while they are here
- U.S. tax law is rarely concerned with whether aliens are legally present in the United States. It is concerned with whether aliens are RAs or NRAs for tax purposes because RAs are taxed on worldwide income but NRAs are taxed only on U.S. income

What We Will Cover

- How does one become a U.S. citizen or a resident?
  - These terms do not mean the same thing for purposes of immigration and taxes (and do not mean the same thing for various types of taxes)
  - We will use the EB-5 program to illustrate this point
- How can you tell if an alien is a resident or nonresident for U.S. taxation purposes?
- What are the responsibilities of employers and service recipients in dealing with employees and contractors?
- How does one cease to be a resident or citizen of the United States and what happens when one does?

Citizenship and Residence

When Is an Alien a U.S. Resident?

- The terms *resident alien* and *nonresident alien* have different meanings for U.S. immigration and tax law purposes
- Immigration law:
  - Lawful permanent resident (LPR): Alien with permission to reside and work indefinitely in the United States
  - Eligibility based on family relationship, employment or (very restricted) self-sponsorship, Diversity Visa Lottery, or Asylee/Refugee Status
- Tax law:
  - Resident alien's residence depends on application of various statutory tests, elections and income tax treaties
  - LPR isn't *necessarily* a tax resident and vice versa
  - Tax residency may be based solely on physical presence

Administration of Immigration Laws

- Several agencies are involved in administration of immigration and nationality laws. Key roles are in:
  - Department of Homeland Security:
    - U.S. Citizenship and Immigration Services (USCIS) – oversees lawful immigration
    - U.S. Customs and Border Protection (CBP) – controls entry of individuals (and goods) into the United States
    - U.S. Immigration and Customs Enforcement (ICE) – investigative arm of DHS charged with criminal and civil enforcement of federal laws governing border control and immigration
  - Department of State
    - Issues visas to immigrants and visitors
    - Issues passports to U.S. citizens
  - Many other agencies (e.g., Departments of Commerce, Defense and Justice, the SSA, various Treasury agencies) play various roles in administering and enforcing the law

Key Immigration Terms

- Alien
  - Unauthorized aliens may be “documented”
- Immigrant (distinguish common from legal meaning)
  - Nonimmigrant and non-immigrant
  - Migrant (entry without inspection (EWI), overstay, breach of status – not always *undocumented*)
- Resident
  - Lawful permanent resident
  - Conditional permanent resident
  - Temporary resident (legalization program ended in 1988)
- Visa
  - Immigrant
  - Nonimmigrant
  - Visa waiver
  - Visa exempt

Lawful Permanent Residency (LPR)

- A foreign national cannot simply apply to immigrate to the USA by choice
- Congress enacted laws to:
  - Accommodate foreign nationals persecuted at home
  - Foster family unity
  - Gain talent and investment
  - Produce a melting pot by restricting maximum influx from any one country
- Most LPRs are petitioned by family or employer "sponsors" and apply for adjustment or immigrant visa based on preference category once immigrant visa (numbers limited by law) becomes available

Lawful Permanent Residence

- Once eligibility is adjudicated, a foreign national may become an LPR via two alternative but equivalent means based on determined eligibility:
  - S/he is admitted to the United States based on an immigrant visa
  - S/he adjusts from temporary (nonimmigrant) to permanent (immigrant) status without leaving the United States
- Both result in alien receiving a “Green Card”:
  - USCIS Form I-551
  - Formal name: “Permanent Resident Card”
  - Prior to 1/20/1999 formal name was “Alien Registration Receipt Card” – see 63 FR 70313

Bases of Permanent Residence

- Family “sponsorship” (5 levels, entailing varying waiting periods)
- Employer “sponsorship” (5 levels, entailing varying waiting periods)
- Self “sponsorship” based on
  - Exceptional, Outstanding, or Executive Talent
  - Investment (EB-5)
- Diversity Visa Lottery (available to nationals of countries with relatively low U.S. immigration levels without other bases to immigrate)
- Refugee or Asylee eligibility

EB-5 Investor Program

- Created by Congress in 1990 to stimulate U.S. job creation and foreign investment (reauthorized for 3 years by Congress in summer 2012)
- EB-5 investors and qualifying dependents become conditional residents for two years until the investment purposes are confirmed to be fulfilled
  - Minimum qualifying investment of $1 million (cannot be borrowed) or $0.5M in a targeted employment or rural area
  - Investment must create commercial enterprise started after 11/29/90 or earlier if existing business is reorganized or expanded via 40% increase in net worth or workforce
  - Investment must create or preserve (in troubled businesses) at least 10 full-time U.S. jobs; indirect jobs count only for investments in regional centers

Who Is a U.S. Citizen (1)?

- U.S. Constitution 14th Amendment
  - **Section 1.** All persons born or naturalized in the United States, and subject to the jurisdiction thereof, are citizens of the United States and of the State wherein they reside
- Birth in the United States
  - Birth in United States (including, in most cases, Puerto Rico, Guam U.S. Virgin Islands and Northern Marianas), except to foreign diplomat
  - Note: U.S. nationals (born in American Samoa and Swains Island) are not U.S. citizens. See *8 USC sections 1408* and *1101(a)(29)*
- Naturalization in the United States
  - Refers to acquisition of citizenship by foreign national
  - See *8 USC section 1401*

Who Is a U.S. Citizen (2)?

- Birth abroad to TWO U.S. citizens
  - Both parents were U.S. citizens when individual was born;
  - At least one parent lived in United States at some point in their life.
  - Proof of citizenship
    - Record of birth abroad, if registered with U.S. consulate or embassy
    - Provision of information required by passport application
    - Certificate of Citizenship – apply using Form N-600
- Birth abroad to ONE U.S. citizen
  - One parent was U.S. citizen when individual born
  - Prior to individual's birth, citizen parent lived in United States at least 5 years, at least 2 of which followed citizen parent's 14th birthday (10 and 5 years if individual was born before November 14, 1986)
  - Proof of citizenship: same as for birth abroad to two U.S. citizens

Who Is a U.S. Citizen for Tax Purposes?

- Immigration and nationality generally apply
- But special rules apply to citizens of the territories (including Guam, Northern Mariana Islands, Puerto Rico and U.S. Virgin Islands) and "outlying possessions" (American Samoa and Swains Island)
- Many citizens are unaware of their status and/or of the tax consequences of citizenship
- See *Carelbach v. Commissioner*, 139 T.C. No. 1 – citizenship does not begin for foreign-born citizen until naturalization has taken place
- Special tax rules also apply to U.S. citizens who relinquish their citizenship or whose citizenship is revoked because of an expatriating act combined with intent to relinquish

Residence for Tax Purposes

- Residence means different things for purposes of different taxes and related regulatory requirements:
  - General Federal tax residence rules *(section 7701(b)*)
  - Federal estate and gift tax purposes (domicile)
  - State tax purposes
  - Regulatory and reporting requirements, e.g., foreign bank account reports, money laundering rules, etc.
  - Home country taxation (and other requirements)
- These rules are not uniform and coordination is erratic
- It is critical to determine when U.S. residence (and citizenship) begins and ends

RA for Income Tax Purposes – Two Tests

- **Lawful permanent resident test** *(section 7701(b)(6))*
  - Sometimes referred to as the green card test
  - Applies to LPRs
- **Substantial presence test** (*section 7701(b)(3)*)
  - Sometimes referred to as the day counting test
  - Applies to non-immigrants

LPR Test

- Alien is resident with respect to any calendar year if he or she is an LPR at any time during such calendar year
- Definition of LPR:
  - Alien has been admitted with, or adjusted to, lawful permanent resident status with the right to reside and work without restriction in the United States, and
  - Status has not been revoked (and has not been administratively or judicially determined to have been abandoned) and
  - Alien is not tax resident of another country under the provisions of a tax treaty
- Many aliens hold green cards but live abroad – they remain tax residents so long as their LPR status has not been taken away

Substantial Presence Test

- Two possibilities:
  - Either 183 days of physical presence in current calendar year *or*
  - CY >= 31 days *and* CY+(PY_1 /3) +(PY_2 /6)=183, where
    - CY = days of physical presence in current calendar year
    - PY_1 = days of physical presence in preceding calendar year
    - PY_2 = days of physical presence in 2nd preceding calendar year

    unless taxpayer shows closer connection to a foreign tax home in current year (see next but one slides)
- If CY < 31, not resident under this test
- Not all days of presence are counted (see next slide)

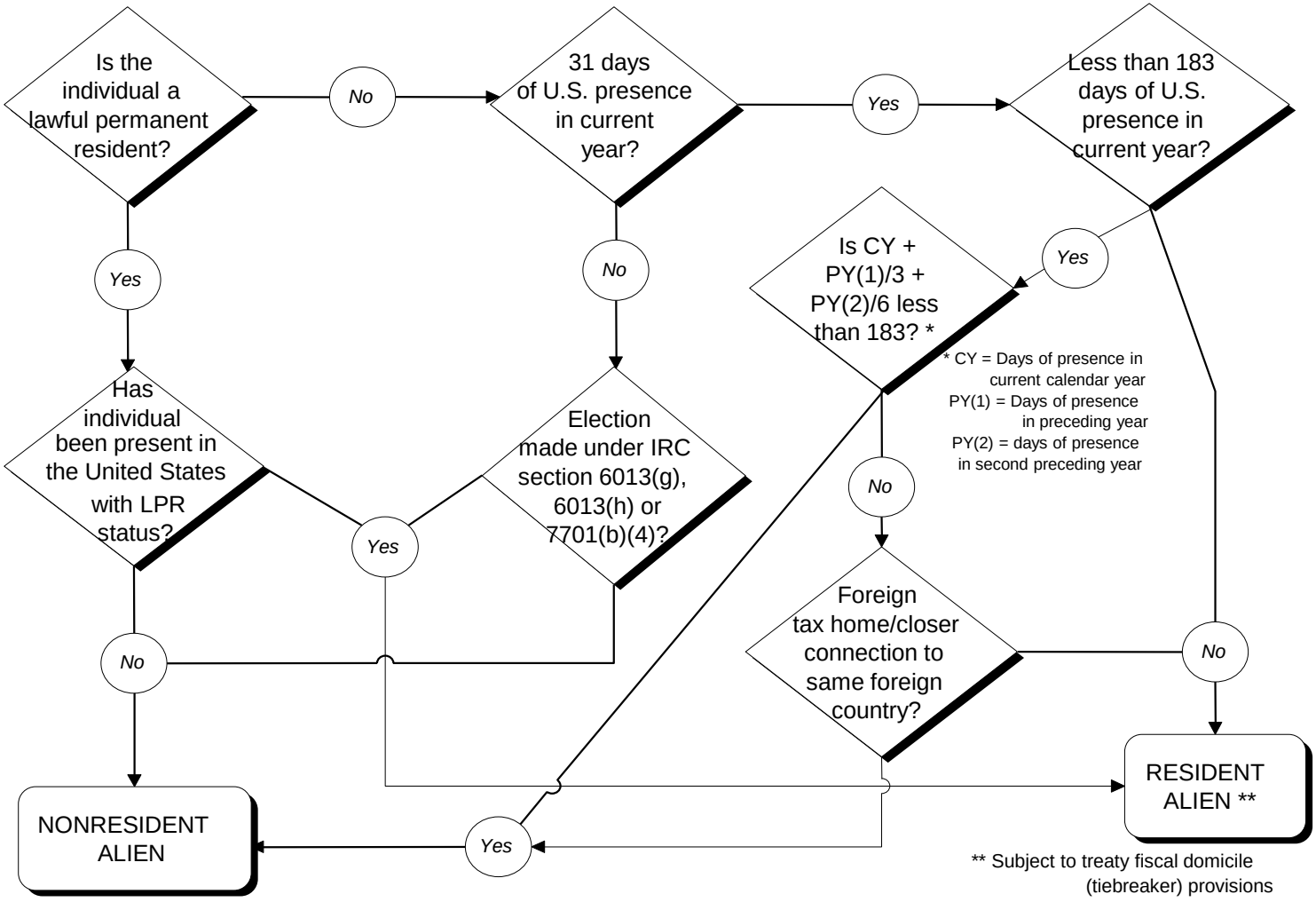
Days of Presence

- Tested on calendar year basis
- Presence during any part of day counts as full day
- Days in transit between two foreign points excluded if stay is less than 24 hours
- Days don't count for some classes of nonimmigrants
  - Students, teachers, diplomats, international organization employees, some professional athletes, regular commuters from Canada or Mexico (special rules for each class)
  - Alien unable to leave because of medical condition which arose while present in the United States
    - Not illness known to alien before coming to United States – so this should be taken into account by medical tourists
    - No exclusion if alien remains beyond reasonable period for making arrangements to leave
    - No exclusion for family members

Foreign Tax Home/Closer Connection

- "Tax home" does not mean tax residence under foreign country's law. It is defined as the taxpayer's regular or, if more than one, his/her principal place of business
- Closer connection focuses on personal connections (location of home, family, belongings, social organizations, bank accounts, driver's license, statements on non-tax documents, etc.)
- Important but not absolutely required that number of days in foreign country exceed number of days in the United States

Diagram of Income Tax Residence Rules



Tax Treaty Tiebreakers

- What if an individual would be a tax resident of the United States and another country?
- Tax treaties almost always provide a tiebreaker based on the U.S. Treasury Model Income Tax Convention (based on OECD Model)
- First, apply domestic tax laws of each country without regard to treaty
- Then, apply series of tests (see next slide)
- U.S. citizens may escape residence of a foreign country under these tests, but:
  - U.S. citizens living abroad remain subject to U.S. taxation on worldwide income
  - U.S. citizens cannot make treaty claim to foreign country unless they are also “resident” in the United States

Tax Treaty Tiebreakers (cont'd)

- If taxpayer would be resident of both "contracting states" under their respective laws:
  - Deemed resident only of the State in which he has a **permanent home available to him**
  - If he has a permanent home available to him in both States, deemed resident only of the State with which **personal and economic relations are closer (center of vital interests)**
  - If centre of vital interests cannot be determined, or if no permanent home is available to him in either State, deemed resident only of the State in which he has an **habitual abode**;
  - if he has an habitual abode in both States or in neither of them, he shall be deemed to be a resident only of the **State of which he is a national**
  - if he is a national of both States or of neither of them, the competent authorities of the Contracting States shall settle the question by **mutual agreement**

Nonresident Aliens

- *Section 7701(b)(1)(B)*
  - Any individual who is not a U.S. citizen or U.S. tax resident
  - Residence may be affected by treaty residence ("tiebreaker") provision (*U.S. Model Treaty, Art. 4(2)*)
  - Note laws applicable to long-term LPRs who give up their status or cease to be resident under a treaty – see later slides

No special provision for new or temporary residents

Transfer Taxes (Estate, Gift, GST)

- RAs and U.S. citizens taxed on worldwide assets; NRAs taxed on assets with U.S. situs
  - Note that gift tax does not apply to gifts of intangible assets, including stock of U.S. corporation or interest in a partnership
- Note special GST rules *(Treas. Reg. § 26.2663-2)*
  - Transfer by an NRA is a direct skip only to the extent transfer is subject to estate or gift tax
  - GST applies to taxable distribution or taxable termination only to the extent the initial transfer to trust by an NRA transferor, whether during life or at death, was subject to estate or gift tax
- Tax on gifts and bequests by "covered expatriates" *(section 2801)* – see expatriation slides below

Residence for Transfer Tax Purposes

- The residence of aliens is based on “domicile”
  - “A person acquires a domicile in a place by living there, for even a brief period of time, with no definite present intention of later removing therefrom. Residence without the requisite intention to remain indefinitely will not suffice to constitute domicile, nor will intention to change domicile effect such a change unless accompanied by actual removal.” *Treas. Reg. §§ 20.0-1(b) and 25.2501-1(b)*
  - Intent is key – immigration status can be an important but not decisive indicator of intent

Residence for Transfer Tax Purposes (cont'd.)

- So what effect does immigrant or non-immigrant status have on determination of domicile?
  - LPR – strong indicator of intent to remain indefinitely
  - Nonimmigrant or lack of status – indicates intent to leave but:
    - Undocumented alien - Rev. Rul. 80-209, 1980-2 C.B. 248 and *Estate of Robert A. Jack v. United States*, 54 Fed. Cl. 590 (2002) (granting government's summary judgment motion that it should be allowed to show that the decedent intended to stay in the United States in violation of his visa)
    - Multiple renewals of nonimmigrant visas – *Elkins v. Moreno*, 435 U.S. 647 (1978) (non-tax case involving domicile for succession purposes of holder of G-4 visa for employee of international organization who remained in the United States for many years), cited by IRS in Rev. Rul. 80-36, 1980-2 C.B. 249

How Can You Tell If an Alien Is a Resident for Immigration Purposes or for Tax Purposes?

Identification of Aliens

- U.S. immigration status is important to employer or payor as well as individuals
  - Appearance, accent and other personal attributes are inappropriate and frequently misleading means to infer or impute status
  - Imputing or assuming non-US status can constitute discrimination by employers (Immigration Reform and Control Act (IRCA)

Documentation of U.S. Immigration Status

- Form I-551: Permanent Resident Card or immigrant visa is possessed in United States only by LPRs
- Form I-94: Issued to nonimmigrants admitted to the United States except Mexican, Canadian, or visa waiver visitors
  - Indicates admission and expiration dates, temporary classification
  - Green I-94W formerly issued to visa waiver visitors now replaced by passport stamps WT (waiver tourist) or WB (waiver business)
  - Form I-766 Employment Authorization Document (EAD) proves unrestricted temporary employment authorization based on status indicated on center front of document
- Taxpayer identification number documents
  - Social security cards by themselves these do not establish LPR status or right to work
  - ITINs issued only to aliens without work authorization who are ineligible for SSNs under restrictive procedures

Employment Eligibility and Status of Aliens

- Employers must verify employment eligibility of new hires who will work in United States
  - Implementing document since 11/87 is Form I-9
  - Both identity & current work authorization must be verified
- Payors of income must determine payee's status as RA or NRA and, in many cases, must collect TIN, for purposes of withholding of tax on:
  - Income from U.S. services – lack of TIN or presentation of an ITIN are red flags since work authorized individuals are eligible for and should be able to obtain SSNs
  - Interest, dividends, rents, royalties, etc.
  - Proceeds of sale of U.S. real property
  - Income of foreign partners in partnership engaged in U.S. trade or business
- IRS Form W-8BEN (NRA) or W-9 (citizen/resident)

Documentation Must Be Consistent

- Information and documentation collected by a payer for tax purposes should be consistent with other information about the payor within the payor entity's records
- ICE and IRS are now cooperating in audits. This is a significant area of vulnerability for a compartmentalized entity in such sub-entities do not and/or are not required to share information.
- ICE now knows to look for "smoking guns" in an entity's tax records. E.g.,
  - Lack of payee TIN or ITIN if payment was for services
  - Information on IRS Form 8233 (claim under tax treaty for exemption on services income) conflicts with employment eligibility

Obtaining an ITIN

- If not eligible for a social security number, obtaining an ITIN is inconvenient and time consuming
- If a TIN is needed for tax treaty benefits, obtaining a pre-return ITIN is difficult or impossible
- IRS recently tightened rules, including adding requirement to turn over passport for up to 60 days or get a copy certified by the foreign issuing agency:
  - www.irs.gov/Individuals/General-ITIN-Information
  - www.irs.gov/uac/IRS-Implements-Interim-Changes-to-ITIN-Application-Requirements-1
  - www.irs.gov/uac/2012-ITIN-Review-Frequently-Asked-Questions-1
  - www.aicpa.org/press/pressreleases/2012/pages/itin-process-aicpa-tells-irs.aspx
  - www.aicpa.org/InterestAreas/Tax/Resources/IRSPracticeProcedure/DownloadableDocuments/ITIN%20comment%20letter.pdf
  - www.irs.gov/uac/Newsroom/IRS-Clarifies-Temporary-ITIN-Application-Requirements-for-Noncitizens-with-Tax-Extensions-and-Many-Foreign-Students

If a U.S. citizen was required to provide a certified copy of a U.S. passport to a foreign government, would the U.S. State Department issue one? Rhetorical question?

Immigration and Tax Laws Collide: Work v. Services

Work and Services

- The meaning and significance of “work” under U.S. immigration law differ from their meaning and significance under U.S. tax law governing payments for “services”, creating significant TIN problems for both payers and payees
- Work authorized individuals must obtain a social security number to provide to employer (or recipient of independent services)
- But many individuals can perform services in the United States without needing work authorization – and those individuals need an ITIN (if paid)

Work and Services (cont'd)

- A key objective of U.S. immigration law is to protect the U.S. labor market
- If compensation for services is U.S. sourced, immigration law requires payee to be authorized to work (whether employee or independent contractor)
- Payment for work is important to the social security system funded by income from services
  - This is the origin of SSA's relationship to SSNs as TINs
  - Aliens not eligible for Social Security accounts because they can't earn income lawfully are deemed not to need SSNs

Work and Services (cont'd)

- Since "work" has a different meaning/significance under U.S. immigration law than under U.S. tax law governing payments for "services", TIN problems arise for payers and payees without TINs if "services" are not "work"
  - If services are not work, no work authorization is needed but payee without work authorization is ineligible for an SSN
- Payment for services associated with an ITIN may raise a presumption that the payee required work authorization that s/he did not have

Self-Employed Individuals

- Self-employment in the United States requires aliens to be authorized to work on bases that are reflected by their immigration documents and deemed “known” to payers
  - E.g., ITIN or no TIN suggests lack of work authorization
- Activities or services that result in honoraria constitute self-employment if they constitute “work” and require authorization for self-employment under immigration law
- Honoraria constitute self-employment income if they compensate services, although exclusion from payee’s income may apply under accountable plan

Employment Eligibility Verification

- Employment eligibility verification (Form I-9) rules that implement worksite enforcement laws enacted by Congress in 1986 apply to independent contractors as well as to employees
  - Form I-9 implements this law for employees
  - Independent contractors become employees (and those that accept their services subject to sanctions) if known or deemed known not to be authorized for services rendered
- Since work authorization varies, alien authorized for certain employment often is not authorized for other employment or self-employment
  - Nonimmigrant needs unrestricted authorization to be self-employed (some temporary contract work is excepted)

Taxation of Unauthorized Aliens

- All persons compensated for “work” in the United States are potentially subject to tax
  - Unauthorized aliens are often not “undocumented”
    - Overstays have expired documents
    - Nonimmigrants who have breached status have unexpired documents
  - Conversely, statutory and tax treaty exemptions apply regardless of whether work was authorized
  - Tax compliance for unauthorized workers is nonetheless very difficult for both payors and payees
- Rationale:
  - Taxes fund services and infrastructure that benefit all persons regardless of status
  - Prevents unfair competition with U.S. workers

Other Important Issues

- The status or employment of a foreign national payee may not be the most important aspect of the payment or carry the greatest potential consequences for the payer:
  - Deemed exports
  - Foreign sanctions administered by Office of Foreign Assets Control (OFAC)

How Citizenship and Residence May Be Lost or Terminated, and What Happens Next

Termination of LPR Status: Immigration Law

- Conditions on 2-year permanent residence are not removed
- Deportation following conviction for aggravated felony or crime of moral turpitude
  - Bar to readmission
- Administrative adjudication of Form I-407 (abandonment of LPR status)
- Expiration or invalidity of “green card” affects the holder’s ability to travel, but does not terminate LPR status

Termination of LPR Status: Immigration Law (cont'd)

- If LPR stays outside the United States for 6 months to a year, use of "green card", even unexpired, is invalid as basis for readmission
- LPR who applies for readmission after lengthy absence of 6-12 months or longer should expect that his/her "ties to the United States" will be questioned
- This can happen even to LPRs who re-enter more frequently but whose passports show long periods of a given year spent outside the United States
- If and when this happens, the LPR can be scheduled for a hearing in which primary residence in the U.S. is examined
  - They may or may not be able to show primary ties to the United States
  - If not, a process begins to revoke their permanent residence
  - Only if and when the revocation is final is LPR status lost in such cases (however, ability to use the green card would have been lost much earlier due to process delays

Can an LPR Claim Tax Treaty Nonresidence?

- Rebuttable presumption that filing federal tax return as a nonresident indicates abandonment of LPR status. *8 CFR. § 316.5(c)(2)*
- Government may not be able to base claim of abandonment of LPR status solely on claim to be NRA under a tax treaty
- But facts supporting tax treaty position may also support government position that alien has abandoned LPR status
  - E.g., claiming "center of vital interests" in foreign country
  - Treas. Regs. warn that claiming nonresidence may be considered as evidence of abandonment
- Taxpayer is not avoiding tax by making legitimate treaty claim to be tax resident in another country, so that by itself is not grounds for exclusion
- Claim of nonresidence during transition period of move to United States may be less problematic for alien

Termination of Residence for Tax Purposes

- Substantial presence test: Last day of physical presence in final year test is met (unless alien has become an LPR)
- LPR test: Last day of physical presence in the United States with LPR status (unless resident thereafter under substantial presence test)
- In both cases, residence will continue to end of calendar year unless:
  - During remainder of calendar year, alien has closer connection to foreign country than to the United States
  - Individual is a resident at any time in the next calendar year

Termination of U.S. Citizenship (Expatriation)

- Foreign born citizens: Fraud in the naturalization process
  - Result is voiding of the purported naturalization, i.e. alien never became a U.S. citizen
- All U.S. citizens (including naturalized and "accidental" citizens): Voluntary relinquishment of citizenship
  - Renunciation procedures established by the State Dept.
  - Expatriating act combined with intent to relinquish citizenship – see http://travel.state.gov/law/citizenship/citizenship_778.html which explains burden on government to prove intent – see *Afroyim v Rusk,* 387 U.S. 253 (1967)
- These are also controlling for tax purposes but see Expatriation discussion below

Can You Come Back?

- Generally, expatriation or cessation of LPR status or tax residence is not a bar to re-entry
- However, IIRAIRA 1996 amended grounds of ineligibility for visas and inadmissibility to the United States
  - Under the so-called Reed Amendment, former U.S. citizen who officially renounces U.S. citizenship and is determined by the Attorney General to have done so to avoid U.S. tax, is inadmissible to the United States and ineligible for a visa (*INA 212(a)(10)(E)*)
  - Exclusion applies only to aliens who officially renounced U.S. citizenship on or after September 30, 1996
  - Law never implemented by regulation, in part because the A-G was never authorized to obtain information from IRS to confirm that a given citizen expatriated for tax reasons. Also, AJCA of 2004 makes tax avoidance intent irrelevant to expatriation tax rules
  - Consider alternative to formal renunciation by claiming acquisition of foreign citizenship as an expatriating act under INA 349a(1) (citizen attests to intent to relinquish citizenship; different from renouncing citizenship per se by oath)
  - See State Department Foreign Affairs Manual, 7 FAM 1266, guidance to U.S. consular officers

Can You Come Back? (cont'd)

- Aside from the Reed Amendment, immigration/visa law basically provides that renunciation or abandonment of LPR or citizenship status renders that individual subject to U.S. immigration law in the same way as other aliens
- As a practical matter:
  - Since this situation bothers some consular officers, they may apply visa presumptions overly strictly or even improperly, denying U.S. visas to such aliens
  - Aliens eligible to "visit" the U.S. under the Visa Waiver program bypass this problem.

Former Citizens and Residents

- All former citizens and former RAs who become NRAs continue to be taxed on certain U.S.-related income under rules generally applicable to NRAs
- Special rules applied to “covered expatriates” can result in continued taxation of certain foreign income and enhanced taxation of certain U.S. income
- See also sections 864(c)(6) and (7) – taxation of income and gains earned while engaged in U.S. trade or business but received when no longer so engaged

Taxation of Covered Expatriates

- In 1995, Congress, prompted by President Clinton, got concerned that prior (1966) regime was ineffective
- 1996 to 2008, Congress enacted three major revisions:
  - 1996 (HIPAA) – Added presumption of tax avoidance if 5-year average net income tax exceeds $100,000 or net worth is $500,000 or more; extended rules to former “long-term residents”; tightened compliance/reporting
  - 2004 (AJCA) – Eliminated tax avoidance test; increased tax and net worth thresholds to $124,000 (inflation adjusted – now $151,000) and $2,000,000; added short-term residence rule for aliens spending more than 30 days in U.S. in any of 10 years following expatriation
  - 2008 (HEART) – Replaced existing regime with “mark-to-market” tax; added succession tax on gifts/bequests to U.S. persons, directly or via trusts; eliminated 30-day short-term residence rule
- No regs. yet. See Notice 2009-85; 2009-45 I.R.B. 1 and IRS Form 8854 (and instructions)

Taxation of Expatriates - Scope

- Laws apply to **“covered expatriates”**, meaning former citizens who expatriate and to aliens who cease to be LPRs for tax purposes if they have been LPRs in at least 8 years within a 15-year period (*section 877(e)*) – these rules were significantly revised effective 6/17/2008
- Because consequences have changed multiple times since 1995, date of loss of citizenship or LPR status is critical
- Since 2004, objective tests based on net worth, 5-year history of income tax liability and 5-year history of tax compliance have replaced tax avoidance intent

Covered Expatriates

- Definition (since 2004)
  - Average annual net income tax of >$124,000 indexed for inflation (> $151,000 for 2012) for the five tax years preceding expatriation
  - Net worth $2 million or more at date of expatriation (not indexed for inflation)
  - Failure to certify 5 years of tax compliance on Form 8854
- Exceptions
  - Dual citizens at birth who have not met “substantial presence” test more than 10 of 15 prior years and who continue to be citizens of and taxed by other country
  - Persons under 18½ who relinquish U.S. citizenship and have not met “substantial presence” test for more than 10 years before date of relinquishment
    - No similar exception for children who were long-term LPRs

Mark-to-Market Rules – Section 877A

- Exit Tax
  - Applies to expatriation occurring on or after 6/17/2008
  - Covered expatriate is deemed to sell all worldwide property for FMV on day before expatriation date and is taxed on gains >$600,000 (indexed post-2008 - $651,000 in 2012) net of losses
  - Makes no difference that asset may continue to be subject to U.S. tax, e.g., U.S. real property interest
  - Section 877A does not address character of gain – could be ordinary, short-term or long-term capital gain. $651,000 exclusion must be allocated among different classes of assets, gain on which may be subject to varying tax rates (e.g., capital gain vs. collectibles gain)
  - Limited step-up for assets owned by alien pre-residence

Exceptions to Mark-to-Market Regime

- **"Deferred compensation items"**
  - Includes interests in qualified and non-qualified U.S. and foreign retirement and deferred compensation plans, other deferred compensation, and interests in property for performance of services to extent not previously included under section 83
  - Exception for deferred compensation for non-U.S. services while covered expatriate not U.S. citizen or RA
  - Tax on **"eligible deferred compensation"** deferred until includible in gross income; collected by 30% withholding tax
    - Deferred compensation is "eligible" if paid by U.S. payor or foreign payor electing, under terms acceptable to IRS, to be treated as U.S. payor
    - Covered expatriate must waive applicable tax treaty benefits and notify payor of status
    - Risk of double taxation, although tax credits may be available

Exceptions to Mark-to-Market Regime (cont'd)

- **Non-eligible deferred compensation** is present valued and treated as received day before expatriation
  - Risk of double taxation; likely no tax credit in foreign country when later received
- **"Specified tax deferred account"**, e.g., IRA's, qualified tuition plan, treated as received day before expatriation
  - No early distribution penalties

Exceptions to Mark-to-Market Regime (cont'd)

- Interests in nongrantor trusts
  - Taxable portion of direct or indirect distributions to covered expatriate subject to 30% withholding tax
  - Applicable whether U.S. or foreign trust
    - How will IRS collect from foreign trust?
  - Recipient must be beneficiary *prior to* expatriation date; will be treated as having waived tax treaty benefits
  - If trust distributes appreciated property, treated as sale of property to recipient
  - No exception for grantor trusts – assets are treated as belonging to expatriate grantor and are marked to market
    - If nongrantor trust becomes grantor trust of covered expatriate, treated as distribution to covered expatriate

Section 2801: New Succession Tax

- Gifts and bequests to U.S. persons from covered expatriate under section 877A taxed to recipient at highest gift or estate tax rate
  - Exceptions for gifts within annual exclusion (currently $13,000) or entitled to charitable or marital deduction
    - Must bequests to resident alien spouse go into QDOT?
  - Exceptions also for property shown on timely filed gift tax return of covered expatriate or included in gross estate of covered expatriate and shown on timely filed estate tax return
  - Credit for foreign gift or estate/inheritance taxes
- Section 2801 often a bigger disincentive to expatriation than section 877A

Section 2801: New Succession Tax (cont'd)

- Special rule for transfers in trust:
  - If domestic trust, tax paid by trust
  - If foreign trust, tax paid by U.S. recipient on distribution portion attributable to covered expatriate's prior transfer in trust
  - U.S. recipient can deduct section 2801 tax attributable to income in computing income tax liability on distribution
  - Foreign trust can elect to be treated as domestic trust
- How will IRS monitor transfers by covered expatriate long after expatriation?

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