Giving up US Citizenship

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Taxation is not the only reason why Americans give up US citizenship, but it is frequently considered by wealthy individuals who plan to live abroad permanently. Unlike citizens of other countries, they remain almost fully subject to US income and death taxes even if they never intend to return to live in America. Despite tax treaties, they are often subject to at least some double taxation.

The US applies all eight tentacles of the "tax octopus." To escape US income, gift and death taxes, you must consider each of the eight tax tentacles:

- **Residence** – you cannot have a *green card,* and you must avoid meeting the *substantial presence* test by spending too many days in the US;
- **Domicile** – you must terminate your domicile in any US state or territory;
- **Citizenship** – you cannot be a US citizen since the US taxes its citizens on a worldwide basis;
- **Marital Status** – you must take steps to eliminate the application of any "community property" rules under which each spouse is entitled to a half interest in all property acquired by the other spouse during the marriage;
- **Source of Income** – you must eliminate or minimise any taxable income from US sources;
- **Location of Assets** - you must eliminate or minimise holding assets that are subject to federal or state gift or death taxes;
- **Timing** – the timing of various acts must be carefully considered (for example, you might sell your family home before you leave but try to postpone receipt of foreign-source income until after you go); and
- **Status of Beneficiaries** – several special factors must be considered if your spouse or any of your other intended beneficiaries remain US citizens or residents.

More than a million US residents become US citizens each year, but fewer than 1,000 Americans per year give up US citizenship. Many of those who do so are returning to a country in which they were born (such as South Korea) that does not permit them to retain another citizenship. Many countries permit dual citizenship but some do not.

If you expatriate, the new *exit tax* law enacted in 2008 aims to make you promptly pay an exit tax on most of your previously untaxed worldwide gains and deferred income. In those cases where this tax is permitted to be postponed, the IRS makes sure that you can't escape the tax or reduce it by using tax treaties. Finally, a nasty new transfer tax is imposed on any US citizens or residents who receive gifts or bequests from you exceeding USD13,000 a year at any time in the future. *The bottom line*: the new rules are designed to remove most or all of the tax benefits you might derive by leaving. The government wants to encourage you to stay and pay.

The US is the only developed country in the world that taxes not only its residents but also its citizens, even those that have never lived in the US or have lived abroad for many years. Having or acquiring another citizenship is a practical necessity for anyone seeking to expatriate. *Dual citizenship* does not eliminate US taxes if one of these is US citizenship. If you leave the US, you must also take into account the income and capital

transfer taxes imposed by the US state and community in which you last lived.

Until 1966, the US made no serious effort to keep Americans from giving up citizenship for tax reasons. The anti-expatriation rules enacted in 1966 were generally unenforceable, but they were beefed up several times during the next four decades. Since 1995, most anti-expatriation rules have also applied to *long-term resident aliens* who have held *green cards* in eight of the last 15 years.

After more than a decade of unsuccessful attempts, Congress finally passed an exit tax in 2008. Any American who gave up citizenship before 17 June 2008 is covered by old rules most of which have been replaced for persons covered by the new rules. Those who expatriate after that date are covered only by the new rules. They do not generally face continued US taxation or tax returns for ten years after expatriation. The new rules also apply to those who have held a *green card* for eight of the last 15 years. One of the unintended consequences of these rules is that some well-advised wealthy foreigners moving to the US are now advised to avoid becoming a US citizen and, if possible, to move to a tax-friendly state in the US as a non-immigrant under some suitable visa category.

The new legislation is quite complex and it contains numerous cross-references to other sections of the US tax law. The explanation contained here is necessarily over-simplified. Anyone seriously interested in exploring possible expatriation must obtain competent professional advice.

The new *exit tax* does not apply to everyone who expatriates. It applies to you if you meet either of two monetary tests, the first of which can change each year because it is indexed for inflation. You must also certify to the Internal Revenue Service, under penalties of perjury, that you have complied with all of your tax obligations for the last five years. If you meet the *income tax test* or a *net worth test* or you do not make the required certification, you are a **covered expatriate.**

If you expatriate during 2010, the *income tax test* will be based on the average of your US federal income tax liability after foreign tax credits for the five years from 2005 to 2009. If your average income was more than USD145,000 a year, you are a **covered expatriate.**

The second test is based on your *net worth* on the day before your **expatriation date.** If your *net worth* is at least USD2 million you are a **covered expatriate.** This amount is not indexed for inflation.

If you don't meet either monetary test and you make the required certification, you are not a **covered expatriate** and you are not subject to the *exit tax*. If you are a **covered expatriate**, the next step is to calculate the *exit tax*.

Certain assets are excluded when you determine your net gain subject to the *exit tax*. These include your interests in *non-grantor* trusts and in eligible *deferred compensation* items such as qualified pension plans, profit sharing plans or qualified annuity plans. An alternative tax system applies to these properties. You will be required to send the payers of these items a new IRS form and they must withhold 30% US income tax on any amounts they subsequently pay you that would have been taxable had you remained a US citizen or resident. You cannot reduce this tax under any tax treaty. US real estate is covered by the *exit tax*; after you expatriate, it will be covered by FIRPTA (the Foreign Investment in Real Property Tax Act) but its basis will be adjusted by the amount of gain to which that asset has been subjected to the exit tax.

If you have an IRA (individual retirement account), or some other *specified tax-deferred account,* you will be treated as receiving your entire interest in that account on the day before your expatriation date. You must pay tax thereon, but you will not be subject to a penalty for early withdrawal.

You determine the *fair market value* and the *adjusted cost basis* of all of your other worldwide assets. Gains and allowable losses are taken into account. Tax is imposed on your net gain over USD627,000 if you expatriate in 2010. The tax rate on long-term capital gains (those on most assets held more than a year) is currently 15%. One observation: Many US taxpayers who sustained large capital losses during late 2008 have large capital loss carryovers and these can be taken into account in calculating their exit tax.

You can elect to defer paying the *exit tax* on some or all of your assets by making an asset-by-asset election to do so until you die or dispose of the asset. You must provide the IRS and maintain satisfactory security.

If you pay the required tax (or you are not subject to it) and you live abroad, you will be taxed as a *non-resident alien individual* provided you do not become a US *resident* under the *substantial presence test* by spending too many days in the US. That test generally permits you to spend an average of up to about 120 days a year in the US without being treated as a resident for US tax purposes. Since that test is based on a moving average of days (including partial days) you have spent in the US over a three-year period, you should obtain professional advice on how that test will apply to you. You will also have to escape the other tentacles of the "tax octopus" and comply with all US immigration law requirements.

If you are a **covered expatriate,** the nastiest part of the new law imposes a special new income tax on all **covered gifts or bequests** exceeding USD13,000 that any US citizen, resident or trust receives from you, either directly or indirectly, at any time after you expatriate. The tax rate will be the highest rate of gift or estate tax imposed at the time of the gift or death, currently 45%. Exemptions apply to gifts or bequests received by your spouse or a qualifying charity. We are still awaiting regulations or other guidance from the IRS as to how this new gift or inheritance tax will work.

The new law does not contain any immigration penalty. It is not a ground for denying you a visa or entry into the US. The 1996 *Reed Amendment* remains in effect but it has never been applied to bar anyone.

You may remain subject to US FBAR (Foreign Bank Account Reporting) requirements even after you leave. The FBAR definitions and rules are different than the tax rules.

Prior US versions of anti-expatriation legislation have been unsuccessful in raising meaningful amounts of revenue. The revenue estimates for this legislation are probably grossly overstated. Why then do the US Congress and parliaments in other high-tax countries waste so much effort in passing these types of rules? The real aim of the exercise is apparently not to collect taxes from those who leave but to discourage you and others from leaving. Governments want to retain their best-paying "customers."

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