THE NAUTILUS GROUP®

GUIDEPOST

Expatriation Tax

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An expatriation tax is a tax on a person who renounces his or her citizenship. In the United States, the expatriation tax provisions apply to both U.S. citizens (who have renounced their citizenship) and green card holders/other long-term residents (who have terminated their U.S. resident status for federal tax purposes).

The Internal Revenue Code (IRC) sections that apply to expatriates[1] were designed to reduce the financial incentive of expatriation for the wealthy. The provisions of the tax apply to a deemed ***covered expatriate***, defined as someone who meets any one of the following three tests:

- Income Tax Test – the expatriate's average annual U.S. income tax liability over the five years prior to expatriation was greater than $190,000 (for 2023 renunciations, adjusted annually for inflation).
- Net Worth Test – the expatriate's net worth is at least $2 million (not adjusted for inflation).[2]
- Compliance Test – the expatriate cannot certify that he or she met all U.S. tax obligations for the five years immediately preceding expatriation, which include timely filing of all U.S. tax obligations and filing U.S. Form 8854 after the expatriation event.

If any one of these tests applies on the date of expatriation, then that person is considered a covered expatriate and the provisions of the exit tax apply. There exists a four-part exception: if a person over the age of 18 received citizenship of both the United States and some other country at birth, if that person continues to hold the citizenship of that other country, if that person is taxed as a resident of that other country, and if that person has been a resident of the United States for not more than 10 of the 15 years prior to renouncing U.S. citizenship, then that person is exempted from the exit tax provision.

If a person is a covered expatriate to whom the exception does not apply, then there are three main areas that could impact the covered expatriate – the exit tax, the withholding tax on tax-deferred assets and non-grantor trusts, and the exit tax on gifts to U.S. citizens.

The Exit Tax: A Deemed Sale of All Assets

The first main provision is a tax on the "deemed sale" of all the expatriate's assets on the day before expatriation. The tax is levied on the net gain of all assets. The tax is calculated as if the expatriate had sold all his or her assets on the day immediately preceding expatriation. The first $821,000 (as of 2023) is excluded, so only a net gain above $821,000 is taxed.

> **Example:** Vladimir has assets valued at $5,000,000 on the day prior to his renunciation of his green card and return to Russia. His adjusted cost basis of such assets is $1,500,000, and he does not qualify for the exception to the covered expatriate test. What amount is subject to the exit tax?
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> *Answer: $2,679,000. Vladimir's net gain from the deemed sale of his assets is $3,500,000, and he is allowed to exclude $821,000 of this gain.*

The actual tax due is whatever tax would apply if the expatriate actually had sold the assets on the day immediately preceding expatriation, and therefore, the tax may be a combination of short-term gain and long-term gain and would be taxed accordingly.

The assets includable in this deemed sale are all assets that would have been included in the expatriate's estate if he or she had died on the day prior to expatriation. Tax-deferred accounts, such as a qualified retirement plan and/or an individual retirement account, are not included.

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[1] IRC §877 and §877A.
[2] The method for determining net worth is described in IRS Notice 97-19.

Possible Deferral of Exit Tax Payment

If the expatriate cannot actually pay the tax from a deemed sale (and this is a very likely circumstance), then the expatriate will have to post acceptable security as collateral against the tax bill for that asset, and the IRS has wide discretion determining what is acceptable. Furthermore, interest is charged until the tax is paid, and the tax must be paid by the earlier of (1) the actual sale of the asset, or (2) the expatriate's death.

This circumstance is likely because the expatriate may own a business, a house, or some other assets which cannot be sold (or that the expatriate does not want to sell). The deemed sale generates what is commonly referred to as paper gain, and if the expatriate does not have the liquid funds available to pay the tax, then the deferral procedure can be used.

Withholding Tax on Tax-Deferred Assets

Certain tax-deferred assets, such as individual retirement accounts and qualified plan accounts, are not considered part of the expatriate's assets under the "deemed sale" described above. Instead, a tax of 30 percent of the total will be paid directly to the United States any time taxable payments are made to the expatriate from the tax-deferred assets. This withholding tax replaces all other taxes on the tax-deferred assets.

To qualify for this treatment, the tax-deferred assets must be eligible, meaning that: (1) the payer must be a U.S. entity or, if a non-U.S. entity, must agree to U.S. withholding and other requirements; (2) the payer be provided U.S. Form W-8CE informing the payer of the expatriate's status; and (3) the expatriate waive permanently and irrevocably all claims to a reduction of the withholding tax under any tax treaty. If these requirements are not met, then the tax-deferred assets will be considered part of the expatriate's total assets and be subject to the deemed sale procedure described above.

Note that the exemption of $821,000 (as of 2023) does not apply to any gain from tax-deferred assets or non-grantor trusts.

Exit Tax on Gifts to U.S. Citizens

Any gifts or bequests made by a covered expatriate to a U.S. citizen will be subject to provisions of the exit tax. The total amount of the gift is reduced by the annual gift tax exclusion amount ($17,000 in 2023), and then is subject to the highest marginal estate tax rate in existence for that year (40 percent in 2023).

> **Example:** Vladimir wishes to give his daughter, Svetlana, $500,000 sometime following his expatriation. Svetlana was born in the U.S. and therefore is a U.S. citizen. What is the exit tax amount?
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> *Answer: $193,200. Svetlana's gift is reduced to $306,800 because she, and not her father, Vladimir, is responsible for payment of the exit tax [($500,000 - $16,000) x 40 percent].*

This procedure also applies to any bequests made upon the expatriate's death, which is the Unites States' attempt to prevent its former U.S. citizens from transferring assets to family members who are U.S. citizens.

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