TAB 5

Relinquishing U.S. Citizenship
Harder than you think!

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CONTINUING LEGAL EDUCATION

Relinquishing U.S. citizenship
Harder than you think![1]

(Beth Webel and Christopher Gandhu, PricewaterhouseCoopers LLP)

Many U.S. citizens (and dual citizens) and long-term permanent residents (i.e., certain green card holders) living in Canada are surprised to discover that they are subject to U.S. income, estate and gift tax, as well as Canadian income tax. In addition to creating ongoing U.S. tax compliance obligations, this may result in significant extra tax down the road. The top U.S. estate tax rate, for instance, is 45% on the fair market value of a U.S. citizen's worldwide estate.

If you are a U.S. citizen, one strategy for dealing with your U.S. tax exposure is to relinquish that citizenship. However, before doing so, it is prudent to consider the implications of the U.S. expatriation rules.

The current rules

New U.S. expatriation rules were passed into law in 2008. The new law applies to any U.S. citizen who relinquishes citizenship after June 16, 2008[2]. Individuals are not subject to these new rules if they have:

• a net worth less than $2 million on the date of expatriation;
• an average net federal income tax liability for the five preceding years ending before the date of expatriation of less than $145,000[3]; and
• complied with all U.S. federal tax obligations for the five years before expatriation.

Exception for dual citizens

An additional exception is provided for certain dual citizens. To qualify, an individual must:

• have acquired both citizenships at birth;
• be a resident of Canada at the date of expatriation and continue to be a citizen and taxed as a resident of Canada; and
• have resided in the U.S. for fewer than 10 of the 15 years in the period that ends with the year during which expatriation occurs.

This is good news for those many Canadians who find themselves U.S. citizens even though they have never spent any significant time in the U.S. For example, this exception should exempt many Canadians who acquired U.S. citizenship because they:

• were born in the U.S. to Canadian citizen parents, but returned to live in Canada when they were young children and have never returned to the U.S.; or
• were born in Canada to U.S.-citizen parent and have never lived in the U.S.

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[1]Originally appeared in PwC Wealth and Tax Matters, Winter 2009
[2] Also applies to certain long-term residents (certain green card holders)
[3] Indexed annually for inflation

To take advantage of this exception, the dual citizen must still be able to certify that he or she has met all U.S. federal tax requirements for the five years prior to expatriation. If this is not the case, the dual citizen must take steps to bring past filings up-to-date. This may require some kind of negotiated settlement with the Internal Revenue Service if the individual has significant unpaid U.S. tax or is facing penalties for failure to provide certain information returns.

Observation

The worldwide property of the expatriate is deemed to be disposed of under the exit tax. This may include property such as principal residences, vacation homes, and rental properties in Canada. General stock investments and interests in Canadian private companies would also be subject to this tax.

What happens if you are not exempt?

If you are not exempt from the new rules you will be subject to special income and gift tax provisions. The provisions are commonly referred to as the "exit tax."

Mark-to-market tax

All capital property of the expatriate is deemed to have been sold for fair market value on the day before the expatriation date. Any net gain on the deemed sale is included in income during the year of expatriation but only if the gain exceeds $626,000.

The expatriate can elect to defer the exit tax. If so, security will have to be posted with the Internal Revenue Service and interest will be charged.

Treatment of special property

Certain deferred plans are handled differently. Instead of a deemed disposition, either the future value of the interest is immediately included in the income or a 30% withholding tax is levied at the time payments are actually received by the expatriate. These special properties may include:

- Canadian and foreign pension plans;
- RRSPs;
- IRAs;
- qualified tuition, education and health savings accounts; and
- certain trust interests.

The $626,000 exemption applies only to gains derived from capital property and does not reduce income inclusions resulting from treatment of special property.

Tax on future gifts

If the expatriate makes a gift to a U.S. person, the recipient (not the expatriate donor) will be subject to U.S. gift tax based on the value of the gift. The U.S. gift tax rates are the same as the U.S. estate tax rates, the top rate being 45%. This gift tax applies to gifts made during lifetime as well as to gifts made under the expatriate's will. As a result, expatriation may not be a viable option if the individual's family members are U.S. persons, because it will effectively subject the expatriate's estate to U.S. tax.

The bottom line

Although relinquishing U.S. citizenship may be an alternative to dealing with certain U.S. tax obligations, the expatriate must do a thorough analysis of his or her worldwide assets before taking any steps to renounce citizenship.

US EXPATRIATION RULES – A SUMMARY

OLD RULES:

Expatriation to avoid tax

- designed to discourage expatriation to avoid U.S. tax
- subject to regime only if:
    - average net U.S. tax liability for previous 5 years > $139,000 (2008 figure, "tax liability test")
    - >$2 million in net worth ("net worth test")
    - fail to comply with U.S. tax requirements for previous 5 years ("tax compliance test")
- applied to former U.S. citizens and lawful permanent residents
- If subject to regime:
    - 10 year post-expatriation alternative tax regime and filing requirements
    - Deemed U.S. citizen if present in U.S. for more than 30 days in any given year
    - required that Form 8854 be filed in order to terminate worldwide taxation even if citizenship or green card has been formally terminated for immigration purposes
- Exceptions:
    - dual citizen at birth and no substantial contacts with U.S.
        - Substantial contacts: never a U.S. resident, never held a U.S. passport and not present in U.S. for more than 30 days during any one of the past 10 years.
    - U.S. citizen at birth, neither parent U.S. citizen at time of birth, give-up U.S. citizenship before age of 18 ½ and not present in U.S. for more than 30 days during any one of the past 10 years

NEW RULES:

What?

- Heroes Earnings Assistance and Relief Tax Act of 2008 (HEART Act) has amended the existing expatriation tax regime
- new rules affect individuals expatriating on or after June 17, 2008
- Introduces exit tax and tax on recipients of certain gifts and bequests.

Who?

- applies to U.S. citizens and long-term permanent residents who renounce citizenship or end their U.S. resident status (i.e.: those who 'expatriate')
- long-term residents means any individual who was a lawful permanent resident (i.e.: green card holder) of the U.S. in at least 8 of 15 taxable years

How?

- imposes a one time mark-to-market tax on deemed sale of worldwide property
- Tax on recipients of certain gifts and bequests.

Covered Expatriates

- Expatriate & meet one of:
  - tax liability test (>$145,000);
  - net worth test (>$2m. broad inclusion); or
  - tax compliance test (5 years).

- Expatriate:
  - a citizen who relinquishes citizenship; or
  - a long-term permanent resident who ceases to be a lawful permanent resident

- Expatriate treated as not meeting the tax liability test and net worth test if:
  - If dual citizen at birth & continue to be a citizen and taxed as a resident of other country & resident of U.S. for not more than 10 of past 15 taxable years; or
  - Relinquish citizenship before age of 18 ½ & been a resident for not more than 10 years
- Compliance test still applies! <u>Therefore, important to be compliant before expatriation</u>

Mark-to-Market Tax:

- All property deemed disposed for FMV on the day before expatriation
- Gain/loss included in gross income for the taxable year of sale
- First $600,000 of inclusion ignored (inflation adjusted)
- Unclear whether the $250k principal residence exemption available in addition to $600k. <u>Therefore, sell house before expatriation.</u>
- Provision to defer payment of tax until property actually sold if provide "adequate security" (interest continues to run) & make

irrevocable waiver of certain treaty rights.

- Step-up in basis – property held on the date an individual became a resident is considered to have basis = FMV as of that date.
- Can elect out of above election (i.e.: if in loss position). Once made, election irrevocable. Unclear whether applies to each item of property or all property.
- Generally, if property is inherited, its basis = FMV when inherited.

Deferred Compensation Items

- DCI means:
  - interests in certain employee pension and retirement accounts;
  - interests in a foreign pension plan or similar retirement arrangement;
  - any deferred compensation plan; or
  - any property or right thereto which the individual is entitled to receive in connection with the performance of services
  - **Does not include any amount attributable to services performed outside the U.S. & while not U.S. citizen or resident**
- Eligible DCI:
  - payor is a U.S. person or a non-U.S. person who elects to be treated as a U.S. person for this purpose;
  - expatriate notified payor of his status as a "covered expat" and irrevocably waives any withholding reduction under treaty
  - **If Eligible DCI then payor withholds 30% of payment as paid**
- Non-eligible DCIs:
  - the present value of accrued benefit is deemed to have been received the day before expatriation (gross income inclusion in year of expatriation)
  - no early distribution tax applies

Specified Tax Deferred Account Items

- Means:
  - an individual retirement plan (i.e. IRAs)
  - a qualified tuition program
  - certain education and health savings accounts
- Consequence:
  - deemed to receive present value of interest on day before expatriation (gross income inclusion in year of expatriation)
  - no early distribution tax

Interest in U.S. Non-Grantor Trusts

- Means:
    - that portion of a trust that the individual is not considered the owner of
    - generally, not treated as owner if no contribution of property
    - above determination made immediately before expatriation
- Consequence:
    - on distribution to covered expats., trustee obligated to withhold 30%
    - withholding on "taxable portion" of distribution – i.e., that portion that would have been includible in gross income if expat. were still a U.S. citizen or resident
    - property deemed disposed to covered expat. at FMV; therefore, trust pays any CG tax
    - deemed to waive treaty benefits with respect to withholding

Gifts and Bequests from Covered Expatriates

- Tax imposed on gift and inheritance from Covered Expats.
- Tax is at highest gift tax rate then in effect (45% in 2009!!)
- Tax paid by U.S. recipient

- Exceptions:
    - gifts below annual exclusion amount ($13,000 in 2009, but no exclusion for gifts for medical & educational expenses)
    - if property otherwise subject to U.S. estate or gift tax (returns must be timely filed)
    - transfers to charity or spouse (legally married)

- Other nuances
    - if transfer to a foreign trust, distributions from the trust subject to the tax as though they were covered gifts or bequests
        - deduction allowed for taxes paid to the extent also included in gross income; can elect to be treated as a domestic trust solely for these purposes
    - If transfer to domestic trust, trust pays tax
    - taxes reduce by taxes paid to foreign country with respect to gift/bequest (<u>but note: no Canadian gift tax!</u>)

UNANSWERED QUESTIONS

1. $600,000 exclusion
   - Can couples double exclusion?
2. Deferred Compensation Items
   - What exactly does "any item of deferred compensation" include?
   - No formal procedure whereby covered expat. must notify employer
   - How does a non-U.S. payor elect to become a U.S. payor?
3. How is present interest valued?
4. New forms coming?
   - 8854 expected to be revised; for now, filed 8854 with 1040

PLANNING IMPLICATIONS

1. Avoid U.S. permanent long-term resident status
   a. planning for individuals inbound into the U.S.
   b. planning for those who have not held green card in 8/15 years
   c. obtain visa instead
2. U.S. citizen/resident working in Canada and wants to expatriate
   a. Canadian pension accrued while U.S. person is a US citizen – practically Canadian pension will not elect to be U.S. person, therefore = future value immediately included in income!
3. Tax creditable in Canada?
   a. Current treaty does not address exit tax
   b. If Canadian resident, trigger tax in Canada
   c. For DCI, may need to argue that 30% withholdings is fully creditable/deductible in Canada

4. Sell residence before expatriation?