

Thinking About Renouncing Your Citizenship? Here is What You Need to Know About the Exit Tax

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This article is designed to provide an overview of the U.S. exit tax consequences associated with expatriating from the U.S. and discuss potential strategies to mitigate the taxes associated with expatriating.

Anyone considering abandoning their U.S. citizenship or ending a long-term U.S. residency must understand that they may be assessed an "expatriation tax." An "expatriation tax" consists of two components: the "exit tax" and the "inheritance tax." Both may be triggered upon abandonment of citizenship or abandonment of a green card. We will discuss both these taxes in more detail below.

HISTORY OF THE EXPATRIATION TAX

The taxation of worldwide income that confronts U.S. citizens may entice some to renounce their citizenship. Section 877 was designed to prevent U.S. citizens from renouncing their citizenship for tax reasons. Section 877 was incorporated into the Internal Revenue Code in 1966. Although Section 877 was revised a number of times since it was enacted, Section 877 remains the principal legal structure for the expatriation tax. Historically, an individual who relinquished his or her U.S. citizenship with "a principal purpose of avoiding U.S. taxes" was subject to a special U.S. income, gift, and estate tax for a period of 10 years after the expatriation. When applicable, the expatriate remained subject to U.S. tax on his U.S. source income at rates applicable to U.S. citizens and the expatriate could be subject to gift taxes in certain circumstances. In 1996, the Code substantially expanded the expatriation tax to not only include expatriating U.S. citizens but to include certain long-term residents (those having U.S. permanent resident status in 8 of the 15 years preceding termination of residency). Expatriates were also subject to U.S. estate and gift tax during the subsequent ten-year period.

The application of the original version of Section 877 required a facts-and-circumstances analysis of an individual's

purpose for expatriation before taxation under Section 877 was triggered. Accordingly, in 1996, Congress added former Section 877(a)(2) to the Code in an attempt to enhance the effectiveness of Section 877 in preventing former U.S. citizens from avoiding their fair share of U.S. taxes. Former Section 877(a)(2) provided that an individual was conclusively presumed to have a principal purpose of tax avoidance for the loss of U.S. citizenship if (i) the individual's average annual net income tax for the five tax years before the date of loss of U.S. citizenship was more than \$100,000 or (ii) the individual's net worth on such date was at least \$500,000.

The presumption did not apply, however, in the case of certain individuals described in former Section 877(c) who, within one year of the loss of U.S. citizenship, submitted a ruling request for IRS determination as to whether tax avoidance was one of the principal purposes for such loss. Individuals who may have qualified for this exception to the presumption included an individual who became a citizen of the United States and another country at birth and continued to be a citizen of the other country after the loss of U.S. citizenship, or an individual who, within a reasonable period after the loss of U.S. citizenship, became a citizen of the country in which the individual was born, the country in which the individual's spouse was born, or the country in which either of the individual's parents was born.¹ Other

individuals who may have qualified for the exception were an individual who was present in the United States for 30 days or less during each of the ten years before the loss of U.S. citizenship, an individual whose loss of U.S. citizenship occurred before he or she attained the age of 18 1/2, and any other excepted from the presumption by regulation.²

The 2004 JOBS Act replaced the prior rules of Section 877 with revised objective standards. Thus, under the revised version of Section 877, the subjective, facts-and-circumstances approach to determine tax-avoidance motive under the prior versions of Section 877 no longer applies. Under the revised objective standard in Section 877(a)(2), the alternative tax regime in Section 877 will apply to any individual who lost U.S. citizenship within a 10-year period immediately before the close of the tax year, if:

1. The individual's average annual net income tax for the period of five tax years ending before the date of loss of U.S. citizenship is greater than \$124,000 (subject to a cost-of-living adjustment for calendar years after 2004);
2. The individual's net worth as of such date is at least \$2 million; or
3. The individual fails to certify under penalties of perjury that he has met the requirements of the income tax title for the five preceding tax years or fails to submit such evidence of compliance as the IRS may require.

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The 2004 JOBS Act borrowed and revised the exceptions in Section 877(c) to provide only two basic exceptions. If either exception applies, an individual will not be subject to the alternative tax regime in Section 877 by reason of either the average annual income tax standard or the \$2 million net worth standard in Section 877(a)(2)(A) and (B).

Any U.S. citizen or long-term green card holder expatriating from the United States may have to pay an exit or expatriation tax.

The first of these exceptions, in revised Section 877(c)(2), applies to an individual who (1) became at birth a U.S. citizen and a citizen of another country and continues citizenship in the other country, and (2) has had no substantial contacts with the United States. To be treated as having had no substantial contacts in the United States, an individual must never have been a U.S. resident (within the meaning of Section 7701(b)), must never have held a U.S. passport, and must not have been present in the United States for more than 30 days during any one of the ten calendar years before the individual's loss of U.S. citizenship.

The second exception, in revised Section 877(c)(3), applies to an individual who meets four requirements:

1. The individual became a U.S. citizen at birth;
2. neither of the individual's parents was a U.S. citizen at the time of the individual's birth;
3. The individual's loss of U.S. citizenship occurs before the individual reaches age 18 1/2; and
4. The individual was not present in the United States for more than 30 days during any one of the ten calendar years before the individual's loss of U.S. citizenship.

The Heroes Earnings Assistance and Relief Act of 2008 (HEART) changed the expatriation rules and established Section 877A. Section 877A established

the term "covered expatriate." Under this new regime, a covered expatriate is required to recognize gain on their worldwide assets as part of a deemed sale on the day before the expatriation date. However, gain of up to \$890,000 (for the 2025 calendar year) is not subject to the deemed sale provisions of Section 877A. A "covered expatriate" is an individual who: 1) relinquishes his or her U.S. citizenship or permanent residence (but only if the expatriate was a U.S. resident during 8 out of the last 15 years), and 2) meets one of the following tests: i) he had a net worth of over \$2 million when they expatriated; ii) he had an average annual income tax burden of more than \$206,000 (in 2025, and indexed annually) during the five preceding years; or iii) he failed to certify compliance with U.S. tax obligations over the last five years. Section 877A also imposes the highest applicable gift or estate tax rate (40%) on U.S. citizens or residents who receive a so-called "covered gift or bequest" from an expatriating individual. In other words, the HEART Act imposes an "inheritance tax" on the recipient of a gift from a covered expatriate.

CONSTITUTIONALITY OF SECTION 877

In *Di Portanova v. United States*,³ an individual took the position that the application of Section 877 to him was unconstitutional on the grounds that it represented an invalid exercise of personal jurisdiction and it was a denial of due process. The court rejected this position. The court also discussed the authority of Congress in the creation and development of the U.S. federal income tax system:

[First, the plaintiff] argues that the provision is an invalid exercise of personal jurisdiction over him. We have held, however, that Section 877(a) is a source-based tax.

The plaintiff recognizes that the United States may tax United States source income at any rate. He contends, however, that Congress cannot base the rate of tax upon the identity of the taxpayer, i.e., expatriates rather than nonresident citizens, and that when it attempts to do that, it is exercising personal jurisdiction over a nonresident alien.

The plaintiff has not shown why this claim of discriminatory treatment * * * converts the tax into one based on personal jurisdiction. If the plaintiff contends that Congress may never tax nonresident aliens on the bases of personal characteristic, he brings into question the distinctions between citizens and aliens and between residents and nonresidents, both personal characteristics from which the plaintiff seeks to benefit. It would be possible for Congress to tax nonresident aliens on their United States income at the same rates it taxes citizens and residents, but it has not done so.

Congress constitutionally may treat nonresident aliens as a special class and subject that class to different tax rates. In *Barclay & Co. v. Edwards*, (citations omitted), the Court held that foreign corporations "constituted a class all by themselves and could be properly treated by Congress The power of Congress in levying taxes is very wide, and where a classification is made of taxpayers that is reasonable, and not merely arbitrary and capricious, the Fifth Amendment can not apply." The plaintiff has not shown why Congress may not also draw reasonable distinctions between various classes of nonresident aliens.

[Second, the] plaintiff argues that Section 877(a) denies him due process because "the means are unnecessary [and] in appropriate to the proposed end, are unreasonably harsh or oppressive, when viewed in the light of the expected benefit, . . . [and] the guarantee of due process is infringed." * * *

Congress has wide discretion in deciding whom to tax and how much.* * * This court said the test is one of minimum rationality.* * * There is a strong policy against invalidating tax statutes, and any rational basis for a taxing statute will justify it.* * * The plaintiff contends Section 877 is ill-suited to preventing tax avoidance because it does not cover all instances. Such arguments, however, are better addressed to Congress. Section 877 was not designed to prevent all tax avoidance. It "was enacted to forestall tax-motivated expatriation." *Kronenberg v. Commissioner* (citations omitted).

The possibility that Congress might draft a better or a more comprehensive statute is not a reason for invalidating the present one. Congress certainly had a reasonable basis for concluding that United States citizens who expatriate themselves with a principal purpose of avoiding taxes should not be given the favorable tax

treatment that nonresident aliens generally receive.⁴

THE CURRENT STATUS OF THE EXPATRIATION TAX

Any U.S. citizen or long-term green card holder expatriating from the United States may have to pay an exit or expatriation tax. The U.S. expatriation or exit tax is assessed against individuals that "expatriate" from the United States. The definition of "expatriate" means (A) any United States citizen who relinquishes his citizenship, and (B) any long-term resident of the United States who ceases to be a lawful permanent resident of the United States (within the meaning of Section 7701(b)(6)).⁵ A long-term resident means any individual (other than a citizen of the United States) who is a lawful resident of the United States (i.e., green card holder) in at least 8 of the last 15 taxable years ending with the year that includes the year of the expatriation. It should be understood that years do not count toward the required 8-year period when "an individual shall not be treated as a lawful permanent resident for any taxable year if such individual is treated as a resident of a foreign country for the taxable year under the provisions of a tax treaty between the United States and the foreign country and does not waive the benefits of such treaty applicable to residents of the foreign country."⁶

The U.S. exit tax is only assessed against individuals that are classified as a "covered expatriate." A covered expatriate is required to recognize taxable gain on their worldwide assets as part of a deemed sale on the day before the expatriation date. An individual is classified as a covered expatriate if his average annual net income tax liability for the 5 years before the date of expatriation is more than \$206,000 (for 2025). For married couples filing jointly, this liability cannot be divided. In addition, any expatriating individual that fails to certify under penalty of jury that he has complied with all federal tax obligations for the 5 preceding taxable years or fails to provide evidence of such compliance will be treated as a covered expatriate. In addition, individuals exiting the U.S. with a net worth of more than \$2 million can

be classified as covered expatriates and subject to the exit tax.

THERE IS SIGNIFICANT TAX FILING REQUIREMENT ASSOCIATED WITH THE EXPATRIATION PROCESS

A covered expatriate is required to file a dual-status individual federal income tax return if he was a U.S. citizen or long-term resident for part of the tax year before he expatriated from the United States. A dual-status income tax return must include both a Form 1040, U.S. Individual Income Tax Return, and a Form 1040NR, U.S. Nonresident Alien Income Tax Return. A Form 8854, Initial and Annual Expatriation Statement, must also be attached to the expatriating individual's income tax return for the year of expatriation. All U.S. citizens and long-term residents who cease to be lawful permanent residents of the U.S. must file Form 8854 in order to certify, under penalties of perjury, that they have been in compliance with all federal tax laws during the five years preceding the year of expatriation. The Form 8854 is used to determine if any exit tax is owed to the IRS. The Form 8854 consists of three parts.

Part I. General information.

Part I of Form 8854 requires that the expatriating individual disclose general information such as their address, list of countries (other than the United States) which he is a citizen, and how the expatriating individual became a U.S. citizen or permanent resident.

Part II. Initial expatriation statement for persons who expatriated.

Part II of Form 8854 is designed to determine whether or not an expatriating individual can be classified as a "covered expatriate." Part II is broken down into three subcategories; Section A, Section B, and Section C.

Section A.

The questions in Section A of Part II is designed to determine if an individual is a "covered expatriate" as the result of having an average annual income tax burden of more than \$206,000 (for 2025) during the five preceding years.

Line 1: Line 1 will require the expatriating individual to enter his U.S. tax liability

(after foreign tax credits) for the five tax years before the date of expatriation.

Line 2: Line 2 will require that the expatriating individual enter his net worth.

Line 3: Line 3 will require the expatriating individual to check the "Yes" box if he became at birth a U.S. citizen and a citizen of another country and, as of the expatriation date, he continues to be a citizen of, and taxed as, a resident of another country.

Line 4: Line 4 will require to be completed by individuals that answered "Yes" to question 3. Line 4 will ask whether or not the expatriating individual has been a resident of the United States for not more than 10 of the last 15 years.

Line 5: Line 5 asks the expatriating individual to check "Yes" if he was under age 18 1/2 on the date of expatriation and if he was a U.S. resident for not more than 10 years.

Line 6: Line 6 asks the expatriating individual to check the "Yes" box if he complied with their tax obligations for the five years ending before the date on which he expatriated. Checking "Yes" to this question will result in an automatic "covered expatriate" classification. Anyone considering expatriating must make certain that they are in compliance with all U.S. tax and filing obligations.

Section B.

Section B of Part II of Form 8854 requires that the expatriating individual complete a balance sheet stating the fair market value and adjusted basis of their global assets and liabilities as of the expatriation date. When completing Section B, the expatriating individual must keep in mind that he can be classified as a "covered expatriate" if his global net worth is \$2 million or more on the date of expatriation. The \$2 million threshold considers all assets worldwide.

Section C.

Section C of Part II of Form 8854 will only be required to be prepared by "covered expatriates." Lines 1a through 1d requires that the expatriating individual disclose to the IRS if they had any eligible deferred compensation items, ineligible deferred compensation items, specified tax deferred accounts, or interests in

grantor trusts. Line 2 will ask the expatriating individual to calculate any taxable gains for the above-mentioned items. A mark-to-market method is utilized to determine the tax consequences of the assets included in Line 2. If, however, the expatriating individual's deemed gain is less than \$890,000 (for 2025), there is no exit tax due.

Section D.

Section D of Part II will be completed by those expatriating individuals who elect to enter into a tax deferral agreement with the IRS with respect to any exit tax. As discussed above, the expatriation or exit tax is calculated as if the expatriating individual sold his assets on the date of expatriation. In certain cases, the tax of a mark-to-market deemed sale may be deferred until the property is sold or the expatriate dies. In order to make the deferral election, the covered expatriate must provide "adequate security" to the IRS and agree to pay the statutory interest on the deferred tax.

CAREFUL CONSIDERATION MUST BE GIVEN TO U.S. BASED RETIREMENT ACCOUNTS

As indicated above, for purposes of computing the expatriation tax, all property of a covered expatriate is treated as sold in a taxable sale on the day before the expatriation date for its fair market value. These rules become complicated when dealing with deferred compensation items such as Individual Retirement Accounts (IRA) and 401(k) plans. We will discuss how these plans are treated for expatriation tax purposes below.

For expatriation tax purposes, covered expatriates must treat an IRA as if it were liquidated on the day before expatriation. The IRA must be disclosed on the Form 8854 and any taxable gains from an IRA will be subject to the expatriation tax. It should be noted that an expatriation does not automatically convert an IRA into a regular investment account. Consequently, the IRA is liquidated when a covered expatriate terminates his U.S. residency, the IRA will retain its deferred tax status. This means that investment earnings will accrue tax-free inside the IRA. As a result, when a covered expatriate takes an IRA distribution after the

expatriation, any income earned in the IRA will still be subject U.S. tax. Unless an applicable income tax treaty applies, the U.S. tax on any investment income withdrawal from the IRA will be subject to a 30 percent withholding tax. In addition, early withdrawal penalties may still apply.

A covered expatriate who has an interest in an IRA should provide the IRA administrator a completed Form W-8CE, Notice of Expatriation and Waiver of Treaty Benefits, within 30 days of the expatriation date. The Form-W-8CE will provide notice to the administrator of the IRA that the individual is a covered expatriate. Within 60 days of receipt of the Form W-8CE, the IRA administrator must provide a written statement to the covered expatriate setting forth the present value of the account's accrued benefits on the date before the expatriation date. The written statement should provide the covered expatriate with the proper information to determine the expatriation tax associated with an IRA.

A covered expatriate is required to recognize taxable gain on their worldwide assets as part of a deemed sale on the day before the expatriation date.

In regard to 401(k) plans, eligible deferred compensation plans may be deferred from the expatriation tax. An eligible deferred compensation plan is an agreement or arrangement under which the payment of compensation is deferred (whether by salary reduction or by nonelective employer contribution). For expatriation tax purposes, a covered expatriate has two options regarding his 401(k) plan. First, a covered expatriate may elect to treat the 401(k) plan as liquidated for tax purposes on the day before expatriation. Any deferred compensation in the 401(k) is taxed at the present value of the covered expatriate's accrued benefit. The distribution from the 401(k) plan must be included on the covered expatriate's Form 1040. In some cases, a covered expatriate may utilize

an income tax treaty to reduce the tax implications of receiving a distribution from a 401(k) plan. If a treaty position is taken, it must be disclosed on the expatriate's Form 1040.

In the alternative, a covered expatriate may elect to defer expatriation tax consequences associated with a 401(k) plan. Such an election is made on a Form 8854. If a covered expatriate makes such an election to defer the expatriation tax on the 401(k) plan, he will be subject to a 30 percent tax on the plan's accrued benefit once a distribution is received. Procedurally, a covered expatriate must list any deferred tax attributed to a 401(k) plan on a Form 8854. Making such an election to defer the expatriation tax requires the covered expatriate to waive any right to claim any tax treaty benefits with respect to the eligible deferred compensation item. A covered expatriate must make a separate election for each qualified 401(k) compensation plan. In addition, the covered expatriate must annually file a Form 8854 to certify that no distributions have been received from the relevant deferred compensation plan. Finally, and probably the most important step to defer a 401(k) plan from the expatriation tax is to timely file a W-8CE with the relevant 401(k) plan administrator. A covered expatriate that wishes to elect to defer a qualified 401(k) plan for expatriation tax purposes must accurately and timely file a Form W-8CE within 30 days of expatriation with the 401(k) plan administrator.

Deferral of the expatriation tax is not available for ineligible deferred compensation plans. Section 457 defines ineligible deferred compensation plans. Section 457 plans are nonqualified, unfunded deferred compensation plans established by state, local government, and tax-exempt employers.

INTRODUCTION TO THE SECTION 2801 INHERITANCE TAX

In addition to the exit tax discussed above, the HEART Act added a new "Inheritance Tax" on certain gifts or bequests made by "covered expatriates" to U.S. recipients. Section 877A imposes the highest applicable gift or estate tax rate (40 percent) on U.S. citizens or residents who receive a so-called "covered

gift or bequest" from an expatriating individual. In other words, the HEART Act imposes an "inheritance tax" on the recipient of a gift from a covered expatriate.

meaning that would ordinarily apply under U.S. gift tax laws. However, Prop. Treas. Reg. 28.2801-2(g) does not apply to the following exceptions to the gift tax that may typically apply:

All U.S. citizens and long-term residents who cease to be lawful permanent residents of the U.S. must file Form 8854 in order to certify, under penalties of perjury, that they have been in compliance with all federal tax laws during the five years preceding the year of expatriation.

The term covered gift means any property acquired by a gift directly or indirectly from an individual who is a covered expatriate at the time the gift is received by the U.S. recipient, regardless of the situs of the gift. A gift generally includes any property transferred during the donor's lifetime for less than adequate consideration.⁷ Adequate consideration generally means the fair market value of transferred property. The fair market value of the property is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell, and both having knowledge of relevant facts. Thus, if Mom sells Blackacre to Child for \$100, and Blackacre is actually worth \$250, Mom has made a gift to Child of \$150.⁸

The inheritance tax is payable by the recipient of the gift or bequest, not the expatriate. There is no expiration of the potential applicability of Section 2801. Thus, a gift or bequest made by a covered expatriate several years (or longer) after expatriation could trigger the tax. The inheritance tax is imposed in addition to the mark-to-market tax paid by the covered expatriate upon exit. Currently, the tax rate imposed by Section 2801 is 40 percent of the value of the gift or bequest. Section 2801 taxes U.S. citizens or residents who receive gifts and bequests from covered expatriates, which would otherwise have escaped U.S. transfer taxes (as a consequence of the donor's expatriation). Transfers by covered expatriates are subject to a tax similar to the gift and estate tax but saddle the donee with the inheritance tax. The term "gift" for expatriation tax purposes has the same

1. The transfer of intangible property by an individual not domiciled in the U.S.;
2. The transfer of property to a political organization;
3. The transfer of stock in a foreign corporation by an individual not domiciled in the U.S.;
4. Annual transfer exclusions;
5. Transfers for educational and medical expenses; and
6. Transfers that occur as the result of a waiver of a pension right.

The Internal Revenue Code and the Proposed Regulations provide limited exclusions from the gift tax. The exclusions are as follows:

1. Gifts disclosed on a timely filed gift tax return by the covered expatriate. The covered expatriate must also timely satisfy any applicable gift taxes.
2. Gifts disclosed on a timely filed estate tax return by the covered expatriate's estate. The covered expatriate's estate must also timely satisfy any applicable gift taxes.
3. Gifts from a covered expatriate to a qualified U.S. charity.
4. A gift from a covered expatriate to their spouse to the extent of a marital deduction under Section 2523 or Section 2056 would have been permitted if the individual was a U.S. citizen or resident at the time of transfer.
5. A transfer by a covered expatriate pursuant to a qualified disclaimer is not considered a gift subject to the inheritance tax.

Think twice about using a foreign trust, foreign corporation, or a partnership to avoid the gift tax.

Some may believe a gift can be transferred through a foreign trust, foreign corporation, or a partnership to avoid the gift tax. This is not the case. To prevent avoidance of the gift tax rules, Section 672(f)(4) broadly authorized the IRS and the Department of Treasury to recharacterize gifts or bequests from a number of entities to avoid gift tax. The regulations under Section 672(f)(4) provide that if a U.S. donee receives a purported gift from entities such as foreign trusts, foreign corporations, and partnerships, the gift will be included in the U.S. donee's income as taxable ordinary income.

REPORTING AND COMPUTING THE GIFT OR INHERITANCE TAX ASSOCIATED WITH EXPATRIATION

A U.S. beneficiary who receives a covered gift is subject to the inheritance tax. The inheritance tax is determined by multiplying the covered gift or gifts by the greater of the highest gift or estate tax provided in the Code. An IRS Form 708, U.S. Return of Gifts and Bequests from Covered Expatriates, must be filed for each calendar year in which a U.S. beneficiary received a covered gift. The due date for the filing of the Form 709 is the 15th day of the 18th month following the close of the calendar year in which the covered gift was received by the U.S. recipient. In certain cases, U.S. beneficiaries may also be required to disclose a covered gift on an IRS Form 3520, Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts. In general, a U.S. person's Form 3520 is due on the 15th of the 4th month following the end of such a person's tax year for income tax purposes, which, for individuals, is April 15th.

EXPATRIATION IS NOT FREE

There are a number of non-tax matters that an expatriating individual must consider. First, individuals considering expatriating from the United States must understand that not only will they be required to pay an exit tax, they also be required to pay \$2,350 to the State Department for the privilege of expatriating.

An expatriating individual must appear in person for an interview.

An expatriating individual must also be prepared to attend an interview at a U.S. embassy or consulate before an expatriation can be finalized. The expatriating individual must bring the following documents and information to the interview:

1. U.S. Passport;
2. Certification of citizenship of at least one other country than the United States;
3. Evidence of any name changes.
4. A completed Form DS-4079.

Section 877A imposes the highest applicable gift or estate tax rate (40 percent) on U.S. citizens or residents who receive a so-called "covered gift or bequest" from an expatriating individual.

Anyone seeking to expatriate from the U.S. must understand that the expatriation interview is just one step in the expatriation process. The interviewer at the embassy or consulate does not have the authority to revoke an expatriating individual's U.S. citizenship or residency. The final decision to revoke an expatriating citizen's citizenship or residency is made by the Department of Homeland Security. The Department of Homeland Security will advise the individual seeking to expatriate from the U.S. in writing whether or not the request to expatriate was granted.

Form DS-4079 must be properly completed.

Finally, anyone considering expatriating must understand that renouncing U.S. citizenship or residency is not automatic. The individual seeking to expatriate must establish by a preponderance of evidence that he is a U.S. citizen or green card holder who performed an

expatriation act voluntarily and with the intent to relinquish U.S. citizenship or permanent residency. An individual may establish by a preponderance of evidence that the expatriation act is voluntary and with the intent to relinquish U.S. citizenship or permanent residency by completing Form DS-4079. Completing the Form DS-4079 is extremely important because if it is not correctly completed the Department of Homeland Security may reject the request to expatriate. However, if the Department of Homeland Security arbitrarily rejects an expatriation request, it may be

possible to bring suit in a United States district court to compel the Department of Homeland Security to reverse its position.

POTENTIAL PLANNING STRATEGIES TO MITIGATE THE CONSEQUENCES OF THE EXIT TAX

The exit tax is an income tax on 1) unrealized gain from a deemed sale of worldwide assets on the day prior to expatriation; and 2) the deemed distribution of deferred compensation plans. A covered expatriate is deemed to have sold most property held worldwide on the day before expatriation. A mark-to-market method imposes an income tax on unrealized gains. In some cases, the exit tax can be substantial. However, with proper planning, the exit tax can be significantly reduced or even eliminated.

One way an individual that plans to expatriate the U.S. can reduce their exit tax liability is to outright gift their assets

to others. Although the HEART Act has imposed an "inheritance tax" on the gross value of a "covered gift," in some cases, the "inheritance tax" can be avoided if a gift is made at least three years prior to expatriation. Regardless of when made, an expatriating individual may also make unlimited tax-free gifts to a spouse that is a U.S. citizen. Another strategy would be to establish a self-settled "expatriation trust." The trust should be formed as an irrevocable, non-grantor discretionary domestic trust in a state that permits such a trust. If established properly and at least three years before expatriation, an "expatriation trust" could significantly reduce or eliminate the exit tax.

CONCLUSION

The foregoing discussion is intended to provide the reader with a basic understanding of the exit tax. It should be evident from this article that this is a relatively complex area of tax law. In addition, it is also important to note that this area of tax law is constantly subject to new developments and changes as Congress enacts new tax laws and the IRS promulgates new regulations. Anyone considering expatriating from the U.S. must begin tax planning as early as possible to avoid the exit and inheritance tax.

End Notes

- ¹ See former IRC section 877(c)(2)(A) (1996).
- ² See former IRC sections 877(c)(2)(B) through (D) (1996).
- ³ 690 F.2d 169 (Ct.Cl.1982).
- ⁴ *Id.* at 179-80.
- ⁵ IRC Section 877A(g)(2).
- ⁶ IRC Section 877(e)(2).
- ⁷ See Section 2511.
- ⁸ Treas. Reg. 25.2518-8.