EXPATRIATION: LOOK BEFORE YOU LEAP

EXECUTIVE SUMMARY
This whitepaper serves as an introduction to the process of expatriation, including:

- Tax filings in the year of expatriation.
- The “covered expatriate” designation and the ramifications of being deemed one to the expatriating taxpayer.
- The exit tax and important planning considerations and strategies to limit the tax consequences of expatriation.

INTRODUCTION: CITIZENSHIP-BASED TAXATION AND EXPATRIATION IN A NEW ERA OF INFORMATION-SHARING AND INTERNATIONAL “COOPERATION”

The uniquely American tradition of citizenship-based taxation has been the official policy of our federal government since before the adoption of the federal income tax. For Americans that live abroad, this tradition ultimately translates to multiple tax residencies and additional tax reporting requirements. In the past, it may have been possible for certain Americans abroad to neglect or ignore reporting of some, or even all, of their income from offshore sources. The advent and more recent implementation of the Foreign Account Tax Compliance Act (FATCA) assures that such neglect will ultimately prove counterproductive and potentially disastrous going forward. No one flies under the IRS’s radar now.
Not surprisingly, this new digital era of FATCA-driven automated info-sharing and tax enforcement has led to a rise in formal expatriations by citizens and long-term residents of the United States. Expatriation is the process by which U.S. citizens and other long-term residents (permanent residents who have held a green card and resided in the U.S. for 8 years in any 15-year period) renounce their citizenship and/or U.S. tax residency. Expatriation requires a formal forfeit of the passport or residence (“green”) card AND a special tax filing — Form 8854 — with the final Form 1040. Form 8854 includes a detailed accounting of the expatriation applicant’s worldwide assets and an attestation of pristine tax filings over the preceding five years. Failure to follow these separate tracks with the USCIS (immigration) and the U.S. Treasury Department (taxes) will result in a failure to cleanly break free from U.S. tax residency. In this new digital era, ignorance is seldom bliss, at least not in the long run.

While that process sounds relatively straightforward, the U.S. Treasury does not acquiesce on its right to tax Americans without some important strings attached. As discussed in the following sections, additional burdens will be placed upon a special class of applicants for expatriation that are classified as “covered expatriates” (a/k/a “covered expats”). There are negative tax ramifications for being deemed a member of this class of expatriates. Much of the strategic financial planning before, during and after the expatriation process for the expatriating citizen or long-term resident will focus upon techniques to avoid becoming a covered expatriate or minimizing the negative tax consequences should the designation be unavoidable.

Ultimately, the decision to expatriate, or not, hinges on both financial and non-financial considerations. While many long-term residence card holders are less tied to their status as “Americans,” there are obvious non-financial reasons for U.S. citizens to remain Americans. This article provides an introduction to many of the key financial issues that a candidate for expatriation should work through with a trusted adviser that understands the complex rules and considerations involved in the formal process of expatriation.

“COVERED EXPAT”: THE TESTS AND THE EXCEPTION

In addition to the immigration and tax filing processes mentioned above, a one-time exit tax will be assessed for certain persons who expatriate that become designated “covered expatriates.” A covered expat includes any expatriating citizen or long-term resident that meets any one of the following three criteria:

- **High Net Worth:** the applicant has a net worth of at least $2 million on the date of expatriation;

- **High Taxable Income:** the applicant had an average annual net income tax liability above $168,000 (2019) (adjusts with inflation) over the prior 5 tax years; OR

- **Non-Compliant on Tax Returns:** The applicant fails to certify, under penalty of perjury, that the taxpayer has fully and compliantly reported income taxes for the preceding five tax years; or the applicant fails to provide evidence of such compliance (i.e., file a complete and accurate Form 8854).
**Exception for Certain Dual Nationals:** A person who otherwise meets the covered expatriate criteria is nonetheless excluded if they meet all of the following three criteria:

- Individual obtained both U.S. citizenship and citizenship of another country solely by reason of birth;
- At the time of expatriation, the individual remains both a citizen and an income tax resident of the other country; AND
- The individual would not have met the U.S. residency test for substantial presence (which oddly only applies to noncitizens under regular income tax rules) for at least 10 years directly preceding expatriation.

The exception appears to be designed to exempt the “accidental American,” who may have been born in the U.S. or to American parents but has always, and continues, to identify herself or himself primarily as a citizen of another country where he or she remains a tax resident and (likely) domiciliary. This dual-nationality exception, however, offers no relief to those who consciously decided to immigrate to (or otherwise take up residency within) the United States, obtained citizenship or remained long-term (8 years or more), and then decided to surrender the U.S. passport or green card and return to their country of origin.

**COMPUTING THE EXIT TAX FOR “COVERED EXPATS”**

**“Deemed Disposition” of Capital Assets and the Capital Gains Allowance:** 26 U.S. Code Section 877A applies an exit tax on covered expatriates based on the net unrealized gain with respect to their worldwide property—as if the applicant had sold off all property as of the day before expatriation. This exit tax on a “deemed disposition” is also known as the “mark-to-market” tax. To the extent that those “realized” gains on the “deemed” sale exceed the $725,000 (2019) exemption, there will be an exit tax owed. Accordingly, given this considerable capital gain exemption, many covered expatriates still avoid paying an exit tax to the U.S. Treasury.

**“Deemed Distribution” of Tax-Deferred Assets:** Not all assets are capital assets and subject to the capital gains tax. It is extremely important to consider the impact of the exit tax on the
retirement plan assets owned by a covered expatriate. If the expatriate owns “Specified Tax-Deferred Accounts,” which includes IRAs or HSAs (health savings accounts), the covered expat pays ordinary income tax on the “deemed distribution” of the account(s). Early distribution penalties will not apply on a deemed distribution – however, the covered expat may decide to take an actual distribution of the account(s), in which case the normal early distribution penalty rules, if applicable, would apply.

These deemed distribution rules also apply to foreign pensions or similar retirement arrangements. There is one noteworthy exception: to the extent that the pension covered non-U.S. source employment income before the expatriating taxpayer had become a U.S. tax resident, that portion of the pension can be excluded from the deemed distribution. Defined benefit pensions, foreign or domestic, are also subject to the exit tax. In determining the valuation of future stream of benefit payments, the expatriating taxpayer will need to have an actuarial statement of present value. Examples of potential application are wide in scope and would include not only employer-sponsored pensions that a school district employee would receive, or an engineer at the AMG factory for Daimler, but also the future benefits from a Swiss pillar 2 pension.

Other retirement plans, such as 401(k) plan or 403(b) accounts, are subject to different rules as “Deferred Compensation.” Eligible deferred compensation plans, including 401k accounts, will provide the expatriate with additional choices on how the exit taxes can be paid:

- Take an actual lump sum distribution before expatriating (which could be subject to early withdrawal penalties before age 59 ½);
- Pay the ordinary income tax upon expatriation – the deemed distribution (no penalty); or
- The expatriate may elect to defer the tax on a qualified plan, so no tax comes due upon exit; however, the expatriate thereby agrees to pay 30% withholding tax on all subsequent distributions and waives all potential treaty relief that might otherwise lower the withholding tax paid by nonresidents on distributions from their U.S. pensions.

The expatriate is given this third alternative for certain eligible deferred compensation plans because these plans have a U.S. plan administrator, which provides the IRS with assurance that the thirty percent withholding will be applied to subsequent distributions (i.e., the plan administrator will bear liability for a failure to properly withhold at the 30% tax rate).

The $725,000 capital gains exemption is not available for these deemed distributions from deferred compensation and specified tax-deferred accounts, as these accounts are not classified as capital assets under U.S. tax law. (Note: Retirement and health savings plan assets are also not available to be utilized in the gifting strategies discussed in the Pre-expatriation Analysis and Planning section, below). Accordingly, for the long-term resident or citizen with considerable deferred compensation and other tax-deferred account assets, the exit tax can be particularly onerous and difficult to avoid through wealth transfer strategies.
Scope of “Worldwide Property” for Net Worth Test and the Exit Tax: Worldwide property is not further defined by the statute, but subsequent IRS notices have made it clear that the IRS will apply very broad rules interpreting the scope of the expatriate’s property. First, the U.S. federal estate tax rules will be used to define the scope of property as including any and all property and interests therein that would have been included in the applicant’s gross estate had the applicant died the day before expatriating. Second, many of the special rules designed to reduce the burden of the estate tax on a decedent’s families – i.e., the special valuation rules for qualified family-owned business interests, as well as the charitable and martial deductions, are not applicable. It would be wise to further assume that the IRS will take some care in scrutinizing all the wealth dispositions reported on the Form 8854, which must include all material asset transfers over the five-year period prior to expatriation:

Schedule A – Balance Sheet

Note. If there have been significant changes in your assets and liabilities for the period that began 5 years before your expatriation and ended on the date you first filed Form 8854, you must attach a statement explaining the changes...

Instructions for Form 8854 (emphasis in italics added).

The scope of “significant changes” clearly encompasses gifts, the surrender of legal powers of appointment, and other transfers applicable to the gross estate calculation, but also includes sales and other transfers for consideration. The IRS clearly wants to look over all material changes to the expatriate’s balance sheet composition over this five-year period prior to expatriation to make sure that sales or exchanges were arms-length transactions at rational valuations and that gifts were in fact completed and accurately reported. Material mischaracterizations, inaccuracies and omissions in the 8854 and/or in any income and transfer tax filings covering this pre-expatriation period could result in a failure to meet the “compliance test.” Such failure triggers the covered expat designation, regardless of the expatriation candidate’s wealth or average income tax liability.

TRANSFER TAXES ON GIFTS/BEQUESTS FROM “COVERED EXPATS”

It is possible that a person who is deemed a covered expatriate could have little-to-no tax liability under the Section 877A exit tax. After all, the net worth test threshold of $2 million of assets in excess of liabilities does not address the cost basis that the expatriation applicant brings to the deemed disposition. If, for example, the expatriating taxpayer recently inherited the bulk
of his or her wealth, it is unlikely that there will be capital gains from deemed dispositions exceeding the $725,000 (2019) exemption, because of the recent “step-up” in basis on the inherited capital assets.

However, there is another key tax component to being deemed a “covered expat” that could cause considerable further U.S. taxation long after expatriation. In addition to the exit tax regime, Congress concurrently created a new transfer (gift and estate) tax provision (Section 2801), which subjects any receipt of a gift or a bequest (above the $15,000 annual exclusion) by a U.S. tax resident from a covered expatriate donor or decedent to U.S. federal gift, estate and/or generation skipping transfer (GST) tax at the highest marginal rate (40% for estate or gift tax and an additional 40% for GST).

There is no lifetime gift and estate tax exemption for the covered expatriate’s transfers of wealth. It is irrelevant whether the wealth being transferred is U.S. situs or non-U.S. situs. The beneficiary, not the covered expatriate nor the covered expatriate’s estate, will owe the taxes on such transfers. Unfortunately, this creates a very messy situation when an American citizen or long-term resident expatriates as a covered expatriate, but his or her family remain Americans. This mess has been exacerbated by the Treasury Department’s abject failure to publish rules and regulations concerning these special transfer taxes that have been coming due for over a decade!

**PRE-EXPATRIATION ANALYSIS AND PLANNING**

The decision to expatriate is often based on a variety of factors, financial and otherwise, but we’ll confine the focus herein on some of the critical financial factors.

It should be quite clear now that the financial burdens associated with formal expatriation hinge dramatically on whether the expat can avoid being designated a “covered expatriate.” Accordingly, understanding the rules and thresholds discussed above will allow the would-be expatriation applicant to determine if, under current circumstances, any of the three tests for “covered expat” status is likely to be triggered. If one or more of these tests are likely to be met, are there strategic steps that can be taken to avoid the “covered expatriate” designation? Consider these possible planning considerations:

- **Compliance:** Make an honest assessment of the transparency and accuracy of all filings and disclosures in the past (5 years) on individual tax return Form 1040, any partnership Form K-1 and all reporting forms such as the FBAR (FINCEN Form 114), Form 8938 (Statement of Specified Foreign Financial Assets), Form 3520 (Annual Return to Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts), and Form 8621 (Information Return by a Shareholder of a Passive Foreign Investment Company or Qualifying Electing Fund), where applicable.
• **Income**: If income is uneven (especially where there is one major income windfall year) and/or heavily laden with stock/options compensation, then the timing of the expatriation filing may be critical. For example, if the latest and prior four years of tax returns saw the average annual tax bill around $140,000, but there is an expected jump in taxable income in the following year or two, then consider expatriating now. On the other hand, if there was a major windfall or gain recognition event that inflated one year’s income tax bill substantially three years ago and raised the 5-year average tax bill above the current threshold for the high taxable income test ($168k in 2019), then wait a couple of years, and try to maintain tax efficiency by avoiding high net annual capital gains.

• **Net Worth**: Consider your ideal estate plan, your cash flow needs going forward, the tax situation of your spouse, children, etc. If the would-be expatriate is above the $2 million net worth threshold, there may be legitimate and manageable ways to remove assets from your taxable net worth (estate) through strategic gifting. If the situation involves an expatriating couple, wealth can be arranged in a strategic manner in advance of expatriating to get one or both spouses under the net worth threshold. If the would-be expatriate is married to a non-U.S. person, then gifting to the non-resident spouse by utilizing the special non-U.S. spouse annual exclusion ($155k in 2019) can prove convenient and effective. Beyond annual exclusions, making “taxable gifts” within the lifetime exemption from gift and estate tax ($11.4 million in 2019) can allow a more rapid and significant reduction in net worth. By shifting highly appreciated assets to the non-resident spouse before they are sold, the expatriating taxpayer may also improve their standing in terms of the high-income test. For more on special financial planning considerations for mixed nationality couples, see this article; for specific discussion regarding gifting strategies to a non-resident spouse, see this article.

In addition to gifting directly or through trusts to friends and family, the expatriating taxpayer might also consider setting up a donor advised fund, which would allow the donor to determine the specific philanthropies to support in future years while retaining some control or influence over the assets. For more information about philanthropic gifting, see this article.

It is important to remember that all types of gifting described above must be made in tax years prior to the tax year of formal expatriation. Current-year gifts will be included in the net worth and exit tax calculations for the expatriating applicant.

• **Assess the Quantifiable Benefits of Expatriation**: For many high net worth expats, there may be no palatable way to avoid the “covered expatriate” designation. In that case, a critical financial consideration may be the tax regime of the current country of residence or of the desired country of residence going forward. A U.S. expat living in a higher-tax foreign jurisdiction may derive little future tax relief from expatriation, while substantially worsening their current tax position should the exit tax apply. Where the expatriate plans to live in low-tax jurisdictions after expatriating, it becomes more likely that the calculus of present and future tax burdens will favor a formal expatriation from the U.S.A., even when there may be exit tax to pay.

• **Minimize the Exit Tax**: Where the decision to expatriate, even as a “covered expatriate,” has been made, the strategic focus shifts to limiting the exit tax. For example, if there are larger portfolio gains (above $725k) and/or
substantial IRAs or other retirement accounts, the would-be expatriate may want to realize capital gains over two or more years prior to expatriation. This may lower the effective capital gains rate, avoid the net investment income tax (a/k/a ACA surcharge of 3.8%) over a portion of the portfolio gains, and elevate the basis of the taxable portfolio when the Form 8854 is filed. Gifting the low-basis (high unrealized gain) assets to family or donating to charitable causes may also prove quite efficient prior to expatriation. If the applicant for expatriation is already subject to required minimum distributions (RMDs), then up to $100,000 can be distributed annually to charity (including the applicant’s donor advised fund) via the qualified charitable distribution. Such distributions trigger no income tax for the IRA account owner, but will count towards satisfying his or her annual RMD—making this a very tax efficient charitable gifting strategy.

INVESTMENT STRATEGIES BEFORE, DURING AND AFTER EXPATRIATION

There is some discussion above about how to manage the taxable portfolio, but it seems prudent to make a few direct points here to stress that expatriation, properly designed and implemented, should have as little impact as possible on investment savings and the growth of the taxpayer’s nest egg. Although the taxpayer may gift certain parts of that nest egg to a spouse or other loved one, and although he or she may intentionally recognize some gains in the years leading up to the year of expatriation, the overriding recommendation is that the expatriating taxpayer remain invested throughout the process and that realizing gains should not translate to going into cash.

Additionally, the expatriating investor will have to decide whether to rollover retirement accounts to an IRA, or whether to take actual distributions of retirement accounts, or whether to take no distributions from the employer-sponsored plan account and pay the withholding tax as funds are distributed over subsequent years to the expatriate. Even if funds are distributed from the retirement accounts, the expatriating investor may decide to maintain those proceeds within an investment account in the United States. Many savvy nonresident aliens look to U.S. brokerages to provide safe, regulated, low cost and highly liquid access to global equity, bond, real estate and other alternative investment asset classes. This often requires management expertise that understands the income tax, gift tax, and estate tax consequences of the investment portfolio as well as the potential role of applicable treaties in reducing the incidence of double taxation on the portfolio income and subsequent wealth transfers.

CONCLUSION: EXPATRIATION DONE RIGHT IS A MEASURED DECISION FOLLOWED BY A WELL-PLANNED AND EXECUTED STRATEGY

There is a clear premium on careful planning well in advance of the application for formal expatriation and the filing of the final Form 1040 and Form 8854. A history of pristine tax filings for five years, managing the five-year average taxable income, managing the worldwide taxable “estate,” and managing the taxable gain on all deemed dispositions of property at the time of expatriation often demand strategic planning long before filing the application for formal expatriation.

Expatriation is ultimately a formal procedure with complex rules and many practical considerations that are best navigated with the assistance of very specialized legal and tax counsel. While the number of Americans that expatriate has been on the rise in recent years, the total number is still a relatively low subset of the millions of Americans who live abroad. Undoubtedly, for those Americans that are tax residents of other countries with significant tax rates on most, if not all, of their earned and passive (investment) income, the economic case for expatriation is less compelling. After all, the higher the foreign tax bill, the greater the probability that the skillful accountant can apply foreign tax credits generated from that high foreign tax bill to eliminate most, if not all, of the expat’s U.S. federal income tax liability.
Given the relatively low numbers of formal expatriations, it should come as little surprise that few lawyers and accountants can demonstrate substantial expertise in helping clients navigate this process. Similarly, very few financial advisory firms have substantial expertise in providing financial planning and investment management advice to clients before, during and after the process of formal expatriation. Expatriation is a process that takes some time, particularly if there will be strategic steps taken in tax years prior to the formal application and filing of Form 8854. In most cases, the proper strategy would have the client remain invested throughout these stages, though potential modifications of investment strategy may be advisable.

This article is merely intended to provide some basic knowledge to help Americans abroad better understand the financial considerations that factor into the decision to surrender their U.S. passport or green card and renounce citizenship or residency. Hopefully, the information herein will provide a practical foundation to help set the table for future strategic discussion and planning should the reader continue to believe this process merits further consideration. Thun Financial Advisors stands ready to play a role in that discussion and to help Americans abroad find the necessary expertise to successfully navigate the path forward.

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