New Expatriation Legislation Passed Unanimously by Congress and Signed by President

June 2008

New Regime Is Onerous to Expatriates

On June 17, 2008 President Bush signed new expatriation legislation unanimously passed by Congress as part of the Heroes Earnings Assistance and Relief Tax Act of 2008 (H.R. 6081) (the "Heroes Act"). There are three particularly significant new aspects of the expatriation provisions of the Heroes Act, which are summarized below.

"Mark-to-Market" Tax

The Heroes Act dramatically changes the current income tax regime applicable to certain U.S. citizens who expatriate and certain long-term U.S. residents (e.g., "green card holders") who end their U.S. residency (referred to collectively herein as "Covered Individuals").

Covered Individuals are taxed under new Code Section 877A (the "mark-to-market tax") as if their worldwide assets* had been sold for their fair market value on the day before expatriation or residency termination. New Code Section 877A allows an exclusion for only the first $600,000 of net gain (as adjusted for inflation in future years).

In addition, any assets held by any trust or portion of a trust that the Covered Individual was treated as owning for U.S. income tax purposes (i.e., a grantor trust) are subject to the mark-to-market tax.

The Covered Individual may elect to defer the mark-to-market tax due to one or more designated assets until his or her death. However, the deferred tax will be subject to interest until payment after death.

Transfer Tax

The Heroes Act also imposes an additional new tax of potentially far-reaching scope: Gifts and bequests to U.S. persons from Covered Individuals (beyond annual exclusion gifts, which are exempt) will be subject to U.S. transfer tax **imposed on the U.S. transferee** at the highest federal transfer-tax rates then in effect (currently 45 percent) under new Code Section 2801.

Withholding from Non-Grantor Trust Distributions

A further change to current law is that Trustees of certain "non-grantor" trusts (i.e., trusts of which Covered Individuals or others are not treated as the owners for income tax purposes) must withhold 30 percent of each distribution to a Covered Individual if that distribution would have been included in the gross income of the Covered Individual if he or she were still a U.S. taxpayer. No treaty of any country with the United States may be invoked to reduce this withholding requirement. Further, if the Trustee distributes appreciated property to a Covered Individual, the trust will be treated as if it sold the property to the Covered Individual at its fair market value. This treatment of distributions to Covered Individuals applies to all future distributions to the Covered Individual: There is no time limitation.

* A very limited category of assets is excluded from the mark-to-market tax and subject to special rules: certain deferred compensation items, certain tax-deferred accounts and interests in non-grantor trusts.

Covered Individuals

An individual falls within the scope of the Heroes Act expatriation provisions if, as of the date of expatriation or termination of U.S. residency, (i) the individual's average annual net U.S. income tax liability for the five-year period preceding that date is $139,000 or more (to be adjusted for inflation); (ii) the individual's net worth as of that date is $2 million or more; or (iii) the individual fails to certify under penalties of perjury that he or she has complied with all U.S. federal tax obligations for the preceding five years.

If an individual is treated as a Covered Individual under items (i), (ii) or (iii) above, there are two limited exceptions which will prevent taxation under the Heroes Act. The individual will not be taxed as a Covered Individual if he or she certifies compliance with all U.S. federal tax obligations and either: (i) he or she was a citizen of the United States and another country at birth if (a) he or she is still a citizen and tax resident of the other country and (b) he or she has resided in the U.S. for no more than 10 of the 15 taxable years prior to expatriation or giving up long-term residence; or (ii) he or she renounces U.S. citizenship before the age of 18 1/2 if he or she was not residing in the U.S. for more than 10 years before the renunciation or the termination of long-term residency.

The current tax regime applicable to expatriates and those who relinquish their long-term residency, which created an alternate 10-year tax regime, will not apply to anyone who expatriates after June 17, 2008, the date of the enactment of the Heroes Act. Those individuals who already expatriated or gave up long-term residency before the date of enactment will continue to be subject to the current 10-year tax regime.

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