BOVE&LANGA
LAW FIRM

Ten Tremont Street, Suite 600 | Boston, MA 02108
www.bovelanga.com | p 617.720.6040 | f 617.720.1919

THE BOVE & LANGA REPORT: ELECTION EDITION

March 2016

Once again, we are in the midst of the presidential primary season. As the potential candidates face off and vie for the nomination, it is not unusual to hear comments from voters along the line of, "If so-and-so becomes President, I am leaving the country." Regardless of which campaign t-shirt you are currently sporting, for most of us this comment is nothing more than an idle threat or joke made during election season, triggered by sitting through yet another political attack ad on television.

All kidding aside, people leave the U.S. for many different reasons and the number of people expatriating is on the rise. In 2015, 4,355 people expatriated from the United States, setting a record high for people surrendering their U.S. nationality. The 2015 total was nearly a third higher than the year before. To keep this in perspective, however, this number is still tiny compared with the 357,983 people who participated in the Iowa Caucus.

Due to the recent increase in expatriation, we felt that it was timely to discuss what expatriation by a U.S. citizen really is and how the process works. And . . . for those of you who are only dreaming of living overseas for a presidential term or two, depending on how the election goes, we have also briefly touched on the tax aspects of being a U.S. citizen residing abroad. Long-term Green Card holders also fall under the expatriation rules but that is a story for another day (and a different Bove & Langa Report).

So, whether you are already mentally calculating the drive time to Canada or reviewing the flight schedules to a location with palm trees, read on . . .

EXPATRIATION AIN'T ALWAYS EASY

So you're dreaming of becoming an expat, drinking gin in a cane chair under a slowly rotating fan. The question is, do you just want a change of lifestyle, or are you opting out of the U.S. tax regime? Many U.S. citizens living abroad call themselves expats, but they are still citizens and so all of their worldwide income and assets remain subject to U.S. taxes. If they want to expatriate for tax purposes, they will have to commit an intentional act to renounce U.S. citizenship. What qualifies? Renunciation to a U.S. consular or diplomatic officer is the most common method, but

citizenship can also be lost by committing treason, joining a foreign government, or joining a foreign military that is engaged in conflict against the U.S. Of course, renunciation of U.S. citizenship doesn't necessarily mean freedom from U.S. taxes. Separate "expatriation" tax rules may apply.

A U.S. citizen who plans to expatriate should follow these steps:

- Review IRS Form 8854, "Initial and Annual Expatriation Statement," to be sure you can fully complete it and swear to the necessary statements. Specifically, make sure all income tax returns, FBARs, and all other applicable U.S. tax and reporting forms are filed, complete, and accurate for the last five years.

- Schedule an appointment at a U.S. embassy or consulate early in the calendar year. The U.S. Department of State requires an appearance in person before a U.S. consular or diplomatic officer. The status and date of your expatriation will not be official until the U.S. Department of State issues a certificate of loss of nationality. Additional tax reporting will apply post-expatriation, and it's valuable to have your status officially confirmed before the tax filing deadline.

- At the U.S. embassy, submit Form 8854 and sign an oath of renunciation.

- File IRS Form W-8CE, "Notice of Expatriation and Waiver of Treaty Benefits," with all eligible deferred compensation providers.

- After receiving the certificate of loss of nationality from the U.S. Department of State, file final income tax returns as required.

The big concern under the expatriation tax rules is avoidance of "covered expatriate" status. A former U.S. citizen will be a covered expatriate under Internal Revenue Code section 2801 if at the time of expatriation: (i) her income tax or net worth exceeded a certain level, or (ii) she failed to certify on IRS Form 8854 that she had complied with all U.S. federal tax obligations for the previous five years. The certification requirement is a trap for the unwary because the "average Joe" could become a covered expatriate, simply by forgetting to file the necessary form. There are very limited exceptions to these rules for certain dual citizens who have resided outside the U.S. for long periods of time before expatriating.

High-net-worth individuals who give up their U.S. citizenship often will be covered expatriates. If an individual receives enough annual income to generate approximately $155,000 of tax, the covered expatriate rules will apply. The income tax will be averaged over a period of five years, so giving away all one's money just before leaving does not solve the problem. Whether or not the income tax threshold is exceeded, if a U.S. citizen has net worth in excess of $2 million on the date of expatriation, she will be a covered expatriate.

Now you've followed all the rules and still find yourself a covered expatriate – so what? Keep reading to find out!

SELLING YOURSELF "OUT" – THE TAX RULES OF EXPATRIATION:

Election's over, are you really going to leave? (Or can we just agree to export the 538 members of the Electoral College?) Depending on your wealth and compliance with the expatriation rules, the tax door might hit you on your exit. Here's how: Internal Revenue Code section 877A treats a covered expatriate as if the individual sold all his worldwide assets on the day before expatriation and an "exit tax" is imposed on the gain. Think of it as a "deemed sale". (The term used in the Internal Revenue Code is "mark to market".)

To calculate the exit tax, begin by (i) identifying the individual's expatriation date, (ii) then identify the assets owned on the day before the expatriation date, generally using the rules applicable to the estate and gift tax (supplemented with complex rules regarding trusts); (iii) then identify the tax basis of each asset and the fair market value of each asset as of the day before the expatriation date. The income on the deemed sale is taxed to the extent it exceeds $600,000 (indexed for inflation to $693,000 for 2016). The allocation of the exclusion amount is applied proportionately on an asset-by-asset (or class of asset) basis. The rate of tax applied depends upon the type of asset. The expatriate is required to file IRS Form 8854 "as soon as possible" after the expatriation date, and pay the exit tax (unless deferral is elected). Why rush to file? Until IRS Form 8854 is filed and proper notice of expatriation is given to the U.S. Department of State, as described above, the exiting taxpayer continues to be subject to the U.S. tax system on worldwide assets.

For example, and very generally, an individual purchases an asset for $100. Years later, the individual expatriates and is a covered expatriate subject to section 877A's exit tax. For purposes of calculating the gain on the deemed sale, the basis of the asset would be $100 (the purchase price). If the asset was worth $250 on the day before the expatriation date, the "deemed sale" rules would impose an income tax on the $150 of unrealized gain.

There are exceptions to the exit tax that apply to (i) deferred compensation; (ii) certain tax deferred accounts – but not IRAs and 529 Plans; and (iii) interests in non-grantor trusts (but watch if it converts to a grantor trust in the future as to the covered expatriate). Instead of the exit tax, a 30% withholding tax applies to distributions from these excepted assets. Whenever one of these exceptions applies, IRS Form 8854 is filed annually to certify as to any distributions that occurred during the tax year.

CASE STUDY: HE'S AN EXPATRIATE AND HE'S OK!

It has been reported that Terry Gilliam of Monty Python fame renounced his U.S. citizenship in 2006, in part as a response to the George W. Bush presidency. This left Terry a naturalized citizen of Britain, the other half of his dual citizenship. Lucky Terry, his timely departure predated the covered expatriate rules we are discussing in this Report, which apply to expatriations after June 17, 2008. When Terry subsequently transfers property to friends and family left behind, any U.S. situated property (as determined under a set of rules in the tax code) will be subject to the U.S. gift or estate tax, at its current highest rate of 40%, but non-U.S. situated property will escape this punitive tax.

In contrast, property transferred from a post-June 17, 2008 covered expatriate to a U.S. citizen or resident will always be subject to a gift or inheritance tax, at the highest applicable rates. For a covered expatriate, it is irrelevant where the transferred property is located, even though some existing U.S. treaties seem to hold otherwise. France and the U.K., for example, have treaties with the U.S. that might arguably limit the application of these rules. And what of the recipient who is responsible for filing the return (the yet to be finalized IRS Form 708) and paying the 40% tax? How is the covered expatriate tax status of the transferor determined absent direct knowledge? From the IRS? But tax information is supposed to be privileged. Yet it is needed. Yet it is privileged. Terry – come back! This is a Monty Python routine that practically writes itself.

YOU CAN'T COME HOME AGAIN . . . OR CAN YOU?

So, you have successfully expatriated . . . congratulations? Although you are no longer a U.S. citizen, you may still have friends, family, and finances in the U.S., and you might want to return for some reason. Your continued ties to the U.S., however, including your visits, could have implications on your expatriation.

If, like Terry in our case-study, you expatriated on or before June 17, 2008, then you will be treated one of two ways depending on your income and net-worth. If you exceeded the income or net-worth tests and spend more than 30 days in the U.S. during a calendar year, you will be treated as a U.S. person for tax purposes. If you run afoul of the "30 day rule" for any year within 10 years of expatriation, then you will be subject to the U.S. person tax regime, including its arduous foreign filing requirements for assets held outside of the U.S. during that year. In the alternative, if you were not a high-income or high net-worth expatriate under the rules that applied then, the 30 day rule does not apply and you can visit the U.S. in a relatively unrestricted manner (depending on how your customs agent is feeling when you enter). Remember, however, if <u>any</u> non-citizen spends too many days in the U.S., the IRS will treat the person as a U.S. resident for tax purposes. So when you book that flight to the good old U-S-of-A, make sure to book your return ticket and don't stay too long.

If you expatriated after June 17, 2008 this 30 day rule does not apply. Remember, residency rules still do, so you could unintentionally become a U.S. person (again!) for tax purposes by spending too much time in the U.S., as noted above.

IS THE GRASS REALLY GREENER?

In addition to political motivations for thinking about leaving our fair shores, who among us has not grumbled about taxes at some point? In the U.S. we are faced with a multitude of taxes. Is there anywhere we can go to escape these burdens? As we learned earlier, for those of us who want such an escape, we must relinquish our U.S. citizenship, and, even then, at a cost. But if we do that, where should we go?

Setting aside for a moment personal circumstances that might direct us to one jurisdiction or another, let's just look at the tax question. There are a number of jurisdictions that are truly tax havens - that is, they impose virtually no taxes on their residents. Some examples include the Bahamas, Dominica (not to be confused with the Dominican Republic), Belize, the British Virgin Islands, and the Cayman Islands. So this is the life - sandy beaches, warm weather, and no taxes. But of course, there is always a trade-off. Don't expect healthcare or personal security to be anything like what you enjoyed in Cleveland, San Francisco, or Boston. And don't be surprised if it takes a few weeks to get your utilities connected, or you can't find your favorite foods in the market. And those foods that are available may cost two or more times what you paid "at home." And when you visit the U.S., don't be surprised that you'll be here on a visa - typically 90 days - and even that will be available only if the jurisdiction you chose has a treaty with the U.S. In any event, you'll be fingerprinted and may be questioned. (Say goodbye to Global Entry!).

Then there are other jurisdictions that may seem desirable but on second glance, are not so ideal. How romantic would it be, for example, to live in an apartment on the left bank in Paris or a chalet in the Austrian Alps or a cliff-side villa on the Amalfi Coast? And who would turn down a manor house in the Cotswolds? You might be surprised to find that the maximum income tax rates in all of these jurisdictions exceed our own!

So, although there can be many reasons to change your citizenship, including lower tax rates and better views than you now enjoy, you'd better give it a lot of thought before you make the move, because coming back may not be as easy as leaving.

On the bright side, you can live this dream in a high-tax jurisdiction if you don't expatriate. If the jurisdiction has a treaty, you may just pay your usual U.S. taxes. Or, you may be allowed to take a tax break for the U.S. foreign earned income credit.

GOD BLESS AMERICA; LONG LIVE THE QUEEN; OR VIVE LA FRANCE?

To gain new citizenship in a country is not always an easy matter. For all but only a handful of countries, you must establish residency there. In many cases, residency is by permit and is long term, after which you may apply for citizenship. And unlike the U.S., not everyone may apply. First, you request long-term residency which may or may not be granted depending upon your finances, health, and character. If you pass those tests, you must then reside in the chosen jurisdiction for anywhere from five to ten years, or even more, before you can apply for citizenship. OR . . . you can go the quick and easy route - just buy your way in.

A few jurisdictions (including the United States, but that, too, is a story for another day) allow you to obtain citizenship by investment. The three most popular programs in order of worldwide acceptance and expense are Austria, St. Kitts & Nevis, and Dominica. Note that the following are approximations. Governments may change their laws and requirements without notice. Dominica is your most affordable and straightforward option for your new citizenship. A Dominica passport, for example, can be purchased by a contribution to the Government Fund of about $200,000 dollars for a family of four. Dominica's national website includes instructions for this option and for a second option of obtaining citizenship through an investment in real estate.

Obtaining a St. Kitts & Nevis passport is a bit more complicated and more expensive than purchasing Dominica citizenship. There are two options for St. Kitts & Nevis: the first is to purchase real estate in the amount of $400,000 or more (and it will likely be more) and pay fees of about $125,000 for a family of four. The second is to invest $300,000 in their Sugar Industry Diversification Foundation, which is not recoverable, for a family of four. Passport processing time for St. Kitts & Nevis is about two to four months and no personal interview or visit to St. Kitts & Nevis is required.

Austrian citizenship is the platinum card equivalent, but also the most expensive to obtain. To obtain citizenship through investment, Austria will require that you invest a significant amount - think $10 million - in an approved Austrian business. As an alternative, it may be possible to make a non-recoverable outright purchase of Austrian citizenship for a cost of $2 million to $4 million. Visits and an interview in Austria are required (lederhosen optional). Other costs, as are required in all jurisdictions, such as due diligence, attorney's fees, and miscellaneous registration fees, are minimal in comparison with Austria's investment or "buy-in" amount. Although obtaining Austrian citizenship is on the pricey side, this is the only purchasable passport that permits entry into the U.S. without a visa and allows you to live in the EU and Switzerland. Therefore, Austrian citizenship is a bargain at twice the price but not for the weak of wallet. (And for the record, the maximum income tax rate in Austria is 50% and it has a 20% VAT - sort

of a sales tax, although there is no gift or estate tax. In comparison, there are no taxes in St. Kitts & Nevis or Dominica.)

CONCLUSION:

We hope that this Bove & Langa Report has educated you about the expatriation process for U.S. citizens and helped put the idea of fleeing the election results in perspective. Before you start packing your bags and looking up Dominica on Google, remember that, in reality, expatriation can be a complex process with significant tax ramifications and reporting requirements. Additionally, once you have left, you may not be able to visit with or provide for those you have left behind in the same unrestricted manner.

Besides, if the worst happens and the candidate you loathe is elected, you can always just live abroad for a presidential term or two. Depending on how things are currently going from your personal political perspective, now might be a good time to start looking at those rental listings for Tuscany. . .