Exit Tax: Eying The Turnstile, Again

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Sometime in the next several weeks to couple of months, American citizens with dual nationality-US and something else-and long-term permanent residents-those that have qualified as lawful permanent residents in the US for 8 out of the most recent 15 years-will learn whether the tax laws will be changed to impose an "exit tax" on anyone dropping US citizenship or terminating residency status. The new rules could make a big difference to permanent residents who lose that status, voluntarily or otherwise, and to American citizens who choose to expatriate. Whether they "hit" a particular individual in a bad way depends on a mixture of details. Some people will prefer the old rules and, therefore, may want to renounce or terminate residency status now, before the changes become law. Others will actually be better off under the new regime.

Almost exactly a year ago Congress considered the same Exit Tax in the context of a very large tax bill. The provisions did not get enacted. Now they are back, and with a new Congress led by new Committee Chairmen, they appear more likely to be adopted.

Where Are We? How Did We Get Here?

Congress currently is working on bills to raise the minimum wage. To give solace to small businesses that feel adversely affected by the wage increase, parts of Congress are pushing for tax breaks for small business. To pay for these, revenue raising provisions have been formulated. Included in these revenue raisers are provisions to replace exiting rules taxing individuals that expatriate with an Exit Tax. (The provisions are labeled "Mark-to-Market" Tax.) The minimum wage bill (HR 2) started on the House side of Congress and was referred to the House Committee on Education and Labor, not the House Committee on Ways and Means, the tax-writing committee, because the bill did not deal with taxes. It was taken up by the House under a special resolution and passed on January 10, 2007. HR 2 was received by the Senate on January 10 and was not referred to the Senate Finance Committee but put on the Senate Legislative Calendar ("held at the desk").

A separate bill, "Small Business and Work Opportunity Act of 2007" (S 349), was introduced in the Senate by Senator Baucus, Chairman of the Senate Finance Committee, taken up by that Committee, approved and ordered reported on the same day, January 22, 2007. (The text of the bill and the Committee Report are available at http://www.senate.gov/ finance/index.html.)

HR 2 was considered by the Senate on January 22, 2007, the same date it was reported by the Senate Finance Committee. A closure motion was made, which would have had the effect of limiting the bill to the minimum wage provisions and preventing tax amendments. This motion was voted down on January 24. The provisions in S 349 were then considered as an amendment to HR 2, with the language of the House bill being struck and the Senate's version of the minimum wage and tax provisions added.

House Ways and Means Chairman Rangel (D-NY), reasonably, did not want the House to go to Conference on HR 2 containing an increase in the minimum wage and an assortment of tax provisions when the tax provisions had never been considered by his Committee. Instead his Committee marked up a separate House small business tax bill (HR 976, the Small Business Tax Relief Act of 2007, introduced by Chairman Rangel and ranking Republican McCrery (LA)). This bill, which contains only tax provisions, no minimum wage provisions, was considered and reported out on Monday, February 12, 2007. It is anticipated that it will be taken up by the House later the week of February 12. Whether the House and the Senate ultimately go to conference on HR 2 or HR 976 is unclear, but a Conference Committee on a bill containing both the minimum wage and the tax provisions, including the Exit Tax, is clearly in the works.

Predictions?

It is impossible to predict whether the new Exit Tax rules will be enacted, and, if they are enacted, when they might come into effect. But the possibility of enactment is very real.

Old Rules; New Rules

The existing rules dealing with individuals that expatriate, in general, continue to apply US income tax for a 10-year period following expatriation. An "expatriate" for tax purposes is a US citizen who renounces or otherwise loses US citizenship under Section 349 of the INA or a long-term permanent resident who loses resident status voluntarily by relinquishing it, or involuntarily by abandonment or removal. Only US source income, as broadly defined in the statute, is affected. Full taxation comes back into play if the individual spends significant amounts of time, more than 30 days per year in most cases, back in the US. Estate and gift tax rules follow the same pattern.

The new "exit tax" would supersede the existing rules. It treats an expatriating individual as though he or she sold everything they own the day before taking action, usually by swearing an oath of renunciation or handing in the green card at an American Embassy. Everything is taxed except the first $ 600,000 ($ 1,200,000 for a couple). An election simply to continue to be treated as US taxpayer and methods for deferring the tax are available, with the usual large number of provisos.

Another particularly nasty rule applies alongside the deemed sale rule. Any gifts or bequests coming back to a US person (citizen or tax resident) will be taxed in the hands of the recipient, and this applies no matter how long ago the donor or decedent expatriated. How all this will work as a practical matter is perfectly unclear. How will the recipient know that her Aunt Harriet used to be a US citizen 25 years ago? How will gifts be traced back to the expatriate? Does the rule only apply to assets that the expatriate owned at the time of renunciation, so wealth acquired subsequently is not affected? And is one supposed to keep track of tainted gifts, which will be taxed, and separate out other "tax-free" gifts?

Also, since the expatriate in all likelihood is going to be living outside the US with all his assets outside the US, collection of the tax is highly problematic, since the US has no mechanism in this circumstance to grab accounts or other assets beyond its borders.

The Quandary-Go Out or Don't Go Out

The prospect of an Exit Tax poses difficult choices for permanent residents living abroad who are vulnerable to loss of status on grounds of abandonment, as well as US citizens and permanent residents who are considering voluntarily terminating their US citizenship or resident status. Act now to avoid the Exit Tax? Wait for the new rules to come into effect? Stay put? The first thing to remember is that important decisions like this need to be carefully considered. This should not be a snap decision.

Got a lot of assets with built-in gain? If you were considering expatriating at some time anyway and you have property with large amounts of built-in gain, you probably should think about doing this before the effective date of this bill in order to avoid being hit with the Exit Tax. If Congress approves the Exit Tax, it will become effective when the President signs the bill, usually one or two weeks after Congress finishes its work. (The effective date rule attached to the provisions states that the effective date will be date of enactment, i.e., when the President signs. It is unlikely that this rule will change.) The provisions for taxing US gifts and bequests coming back to the US can be a significant factor. In addition, in particular cases, provisions contained in the new rules aimed at beneficiaries of a trust can create serious problems and invite tortuous audits.

The problem will be timing. It is difficult to renounce US citizenship on short notice. It normally requires several weeks. State Department forms need to be filled out and presented in advance; an appointment with a consular officer must be booked; a tax form (Form 8854) must be completed. Of course, a renunciant must have a satisfactory "other" nationality. In contrast, terminating permanent resident status can be accomplished relatively quickly.

If the expatriate is not current with his tax filings, these have to be brought up to date. An individual renouncing citizenship or terminating long-term residency must certify that he has complied with all US federal tax obligations for the preceding five years and be prepared to prove this if asked. Otherwise, he will be treated for tax purposes as not having renounced. In other words, he will remain a US taxpayer even though he is for US immigration purposes an alien.

Don't have lots of assets with built-in gain? Thinking about spending time back in the US and maybe earning US source income? If one doesn't have property with built-in gain in excess of the $ 600,000 exemption level-for example, if one has mainly cash and cash equivalents, one might prefer to remain under the new rules. You would not have to face the provisions taxing future US source income, and you would not have to worry about the 30-day rule. If you are not too concerned about the taxing of remitted gifts and bequests, this is further encouragement to wait to expatriate.

Dual Nationals And Long-Term Residents-In The Middle Of The Dilemma

Dual nationals (US and something else) and long-term residents, not rich native-born Americans, are the ones most affected by these developments. There are many "Accidental Americans"--Americans by virtue of having been born in the US to parents temporarily present here or having been born abroad to a US parent. Mexico and Saudi Arabia, for example, are the home to many dual nationals. They need to think fast what to do. There are also a surprising number of long-term green card holders living outside the US in London, Paris, Geneva, Hong Kong, Taipei, and elsewhere. They must ponder not only the possible enactment of the exit tax but also the fact that the IRS and the DHS are looking to exchange more information about people's whereabouts, as part of the anti-terrorism push. As a result, permanent residents who are living abroad without benefit of a reentry permit may face a higher risk of involuntary loss of status on grounds of abandonment. Considering all this, they may want to move closer to the turnstile marked "Departure".

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