

Facebook's Saverin Left U.S. as a Taxpayer, Not a Traitor

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Eduardo Saverin, the co-founder of the social network and Facebook Inc. (FB), stands accused of violating the social contract -- the idea that government is based on an agreement among its citizens to ensure mutual protection of person and property.

His decision to give up his American citizenship before the Facebook initial public offering drew criticism for his perceived breach of financial and patriotic duties, including the duty to pay income taxes.

He is even the target of legislation called the Ex-Patriot Act, proposed by Democratic Senators Charles Schumer and Bob Casey, that would ban wealthy expatriates such as Saverin from ever re-entering the U.S. This is seen as a more stringent version of current law, known as the Reed Amendment, which permits the denial of re-entry to tax-motivated expatriates, but does not require it. The Ex-Patriot Act would also tax an ex-citizen's capital gains at 30 percent for 10 years.

The proposal and the hubbub around the Saverin case are based on two misconceptions about the tax consequences of surrendering a passport and an individual's motivations for giving up citizenship.

We do not fault Schumer, Casey and others for misunderstanding the mechanics of U.S. taxes on people who leave. These details are tucked away in a few pages that only a handful of lawyers are aware of in an increasingly complex tax code.

Deemed Sale

The critical confusion is that Saverin, and others like him, somehow avoid U.S. capital-gains tax by moving to another country -- often a no- or low-tax jurisdiction -- and then selling property after they give up their citizenship. In fact, the act of expatriation itself constitutes a deemed sale: an immediate income tax (known as the exit tax) is imposed on all of the individual's property. The government taxes the gains that accrued while the person was a U.S. citizen. It is only the gains accumulated after expatriation that escape taxation. In other words, the Treasury gets its fair share of the tax before the person surrenders his passport.

In Saverin's case, the difference between his initial investment in Facebook and the fair-market value of the stock upon his expatriation -- less an exemption -- is subject to the U.S. income tax. The simple act of giving up his U.S. citizenship caused the capital-gains tax to be due and payable immediately. The government will collect significant sums as a result.

Saverin won't be subject to U.S. income tax on any appreciation between the time of his expatriation and the actual sale of his stock. When Saverin surrendered his citizenship, there was a strong likelihood -- but no guarantee -- that his actions would allow him to avoid taxes on such gains.

Although the Facebook IPO looked like a sure winner at the time, the gains may prove to be significantly less than what he had hoped for. If the stock continues to decline, below its value when Saverin gave up his passport, he will have actually paid capital-gains tax that he could have avoided had he kept his citizenship.

Regardless of the amount of gain Saverin may avoid by expatriating, his status when that gain is recognized places him in the same tax-preferred position as any other nonresident noncitizen who invests in the U.S. Our tax system is structured to encourage foreign investment. Expatriates might not want our passports, but we still want their capital.

An even-lesser-known tax consequence of expatriation is that any U.S. citizen or resident who inherits property from Saverin or any other wealthy ex-American is subject to a special inheritance tax.

Inheritance Tax Exposure

Unlike the U.S. estate and gift taxes, which are imposed on the person who makes the gift or on the estate of the person who dies, the inheritance tax is imposed on the recipient of the property. Should

Saverin ever have children or grandchildren who become U.S. citizens or residents and receive gifts or inheritances from him, the Treasury will have another bite at his tax apple.

We cannot claim to know why Saverin gave up his citizenship. In our experience, however, we know that the motivations of expatriates are often far more complicated than the desire to avoid taxes.

When we, as lawyers, counsel clients on this challenging decision, the conversations always turn first to personal and financial security. Many wealthy Americans are more concerned about preserving their wealth in a tumultuous financial system than they are about avoiding taxes. This is particularly so as people seek out stable investments internationally in the face of increasingly onerous government regulation. (If you haven't heard of the Foreign Account Tax Compliance Act, or FATCA, we suggest some not-so-light reading.)

We find that these individuals love the personal and economic liberties that are fundamental to the American social contract and are more than willing to contribute to the costs of securing these liberties. But many believe that the current state of our politics and government cannot provide a long-term guarantee of these liberties.

No one is saying there aren't people who give up their citizenship to obtain hoped-for tax benefits. This may very well have been Saverin's motivation. But ignoring the other considerations in making such a decision is a failure to see the whole picture.

We believe the U.S. laws are properly structured to impose appropriate taxes on American expatriates. We also believe that paying attention to the many reasons that people decide to leave their country would go further in encouraging our successful and productive citizens to remain parties to our social contract.

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