New York Law Journal

Trusts&Estates

WWW.NYLJ.COM

An ALM Publication

TUESDAY, JANUARY 19, 2016

Start Spreading the News: **Tax Issues** for **Expatriating** New Yorkers

BY DAVID PRATT,
SCOTT A. BOWMAN
AND MICHAEL ROSENBLUM

For an increasing number of New Yorkers, the decision to relocate to avoid onerous income and estate tax no longer stops at the city or state line. These taxpayers are going one step further.

Because the United States is the only country that taxes on the basis of citizenship, these taxpayers are considering saying "so long" to Uncle Sam, surrendering their U.S. citizenship, and "expatriating" to a new homeland. This article examines U.S. expatriation issues, particularly highlighting the tax consequences and recent Proposed Treasury Regulations, together with New York-specific considerations for those seeking to hail a taxi out of taxation.

History of Expatriation Taxes

The Heroes Earnings Assistance and Relief Tax Act of 2008 (the HEART Act) enacted Internal Revenue Code[1] (IRC) §§877A and 2801 to prevent avoidance of U.S. income and transfer taxation by certain U.S. citizens and residents (U.S. persons) who expatriate on or after June 17, 2008. Prior to the HEART Act, these U.S. expatriates were subject to an alternate tax regime under §§877 and 2107 for 10 years following expatriation. The new regime includes an "exit tax," which is an income tax, and the so-called "§2801 tax," which is a transfer tax.

BIGSTOCK

Who Is Subject to These Taxes?

The current expatriation regime applies to "covered expatriates" (CEs) and those receiving transfers from CEs.

Unless an exception applies, a CE is a nonresident alien individual who relinquishes U.S. citizenship or ceases to be a long-term resident (a U.S. green card holder in eight or more of the prior 15 years) and who has (1) a net worth of at least $2,000,000, (2) an average annual net income tax over the five years preceding expatriation of more than $160,000 (for 2015, indexed annually for inflation), or (3) failed to certify and substantiate U.S. tax compliance for the past five years.

Exceptions exist for individuals who (1) were dual citizens at birth, taxed as a resident of a foreign country, and have resided in the United States for less than 10 of the last 15 taxable years prior to expatriating, or (2) relinquish U.S. citizenship before age 18½ and have resided in the United States for less than 10 taxable years prior to expatriating.

The Exit Tax

Section 877A imposes a one-time income tax on CEs upon renouncing their U.S. citizenship or relinquishing their U.S. greencard. The exit tax is calculated by treating all of the CE's property as being sold for fair market value on the day prior to the expatriation date. Any realized gain on this deemed sale is recognized.

DAVID PRATT *is a partner at Proskauer Rose and the chair of the private client services department.* SCOTT A. BOWMAN *is a partner, and* MICHAEL ROSENBLUM *is an associate, in the department.*

For purposes of computing the exit tax, assets are valued under general transfer tax valuation rules (i.e., fair market value on the date of transfer). IRS guidance also provides that the transfer tax special valuation rules (i.e., Chapter 14 of the Code—§§2701 through 2704) apply as if the CE were transferring property to family members. Currently, valuation discounts for lack of marketability discounts, lack of control, or fractional interests should apply.[2] Accordingly, traditional estate planning techniques using such discounts may be implemented as part of pre-expatriation planning to reduce a CE's exit tax exposure.

A CE is permitted to exclude up to $690,000 of gain (for 2015, indexed annually for inflation). The exclusion is allocated pro rata among the expatriate's assets subject to the exit tax on the basis of the amount of gain recognized with respect to each asset. This pro rata allocation is intended to prevent the CE from allocating the exclusion amount to ordinary income assets and other assets taxed at higher rates, such as collectibles.

There are two important exceptions from the exit tax base for "eligible deferred compensation items" and for certain "tax deferred accounts." Rather than being subject to the exit tax, eligible deferred compensation items are subject to 30 percent withholding at the source of payment on the "taxable payment," meaning any payment to the extent it would be includible in the gross income of the CE if such expatriate continued to be subject to tax as a U.S. citizen or resident. The exit tax also provides that "tax deferred accounts," such as individual retirement accounts and tax-preferred education and medical savings accounts, are treated as being distributed in their entirety to the CE on the expatriation date. No early distribution taxes apply.

Because the deemed gain triggered by the exit tax will not have corresponding liquidity, deferral of the tax payment is permitted, subject to an interest charge. If the CE so elects, the pro rata portion of the exit tax associated with a particular asset can be deferred until actual disposition. As part of the election, the CE is required to provide "adequate security" for payment of the tax, which generally means a bond conditioned on the tax payment. Any CE making the election must also irrevocably waive any rights under any U.S. income tax treaty with respect to the collection of the exit tax. The liquidity issues associated with expatriation are often difficult ones, as CEs rarely wish to continue ties with the IRS during the deferral period, but may lack the liquidity to make an immediate tax payment.

The §2801 Tax

Section 2801(a) taxes U.S. persons receiving, directly or indirectly, an otherwise nontaxable gift or bequest in excess of the gift tax annual exclusion (currently $14,000) from a CE (a "covered transfer"), unless a charitable or marital deduction would have been available had the expatriate been a U.S. person. Whether the CE acquired the transferred property before or after expatriation is irrelevant. The §2801 tax is imposed at the highest estate or gift tax rate on the date of receipt (currently 40 percent), with a credit for any foreign estate or gift taxes.

Section 2801 treats domestic trusts as U.S. citizens, so domestic trusts receiving covered transfers are liable for the §2801 tax. A foreign trust that elects to be treated as a domestic trust for §2801 purposes (an electing foreign trust or EFT) must also pay §2801 tax directly. Foreign trusts that do not make this election (non-electing foreign trusts or NEFTs) are treated as non-U.S. persons, and distributions from a NEFT to a U.S. person triggers the §2801 tax.

Pursuant to Notice 2009-85, payment of the §2801 tax is deferred until the issuance of final guidance by the IRS. The Treasury Department has recently promulgated Proposed Regulations, providing some insight into the proper application of the §2801 tax regime.

Proposed §2801 Regulations

Section 2801 Tax Exceptions. The Proposed Regulations provide five exceptions to covered transfers: (1) taxable gifts timely reported and paid on a gift tax return (Form 709), (2) gross estate property timely reported and paid (including QDOT distributions) on an estate tax return (Form 706), (3) normally deductible charitable transfers, (4) normally deductible marital transfers including QTIP and QDOT assets if valid elections are made and (5) qualified disclaimers.

Indirect Transfers. The Proposed Regulations list five types of indirect transfers that trigger §2801 tax: (1) acquisitions by a business association (i.e., a corporation or partnership) owned by the U.S. person (but only to the extent of the ownership interest), (2) acquisitions by an entity not subject to §2801 tax on behalf of a U.S. person, (3) transfers by a CE to satisfy debts or liabilities of a U.S. person, regardless of the payee, (4) transfers resulting from a non-CE's power of appointment granted by a CE over property not in trust, and (5) "other transfers" not made directly by the CE to a U.S. person (a catch-all).

Foreign Trust Intermediaries. Section 28.2801-2(e) specifically includes as a "U.S. recipient" any U.S. person receiving a distribution from a NEFT if the distributions are attributable to covered transfers to the NEFT. Sections 28.2801-2(f) and (g) further confirm that such a distribution is a covered transfer if attributable to a transfer made to the NEFT. Under §28.2801-3(d), however, EFTs are not "looked through" to assess the status of beneficiaries; because EFTs are liable for the §2801 tax upon receipt of property from the CE, there will be no covered transfer upon distribution of such assets to U.S. beneficiaries.

Special Rules for Foreign Trusts. Section 28.2801-5 governs the application of the §2801 tax regime to NEFTs. Recognizing that a foreign trust can be funded by covered and non-covered contributions, §28.2801-5(c)(1) creates a "§2801 ratio" to determine the NEFT's covered and non-covered portions. The covered portion includes any covered transfer and any appreciation and income accrued as a result of such transfers. The §2801 ratio is determined as follows:

$$\frac{[(\text{Pre-Contribution FMV of Covered Portion of Trust}) \times (\text{Pre-Contribution \S 2801 Ratio})] + [\text{Current Contribution FMV Attributable to Covered Transfer}]}{(\text{Post-Contribution FMV of Trust})}$$

Section 28.2801-5(c)(1)(ii) directs that once §2801 tax is timely paid on undistributed foreign trust property, that property is no longer deemed to be from a covered transfer. If the foreign trustee or U.S. recipient is missing information necessary to perform the above calculation, the entire distribution is deemed attributable to a covered transfer (i.e., the §2801 ratio is 1 and the entire distribution is subject to the §2801 tax).

Section 28.2801-5(d) describes the mechanics of the election by which a foreign trust is treated as a domestic trust. The election subjects the EFT to the §2801 tax on (1) all covered transfers received by the trust that year and for future years in which the election remains effective and (2) the portion of the trust attributable to covered transfers in prior years. Because previously taxed covered transfers are removed from the determination of the covered portion of the trust under §28.2801-5(d)(2), upon election, the §2801 ratio of the EFT becomes zero until the election is terminated and a subsequent covered transfer is made. However, distributions in prior calendar years by the EFT remain subject to the previous §2801 ratio and taxable to the U.S. beneficiary.

A valid foreign trust election is effective as of January 1 of the calendar year for which the Form 708 on which the election is made is filed and remains effective until terminated pursuant to §28.2801-5(d)(5)(ii). If the NEFT received no covered transfers that year, the Form 708 on which the election is made must be filed by the 15th day of the sixth month of the calendar year following the close of the calendar year for which the election is made, but an automatic six-month extension is permitted by filing a Form 7004 before the Form 708 filing deadline. The election is automatically terminated if: (1) the foreign trust fails to timely file the Form 708 and pay any §2801 tax then due, or (2) fails to pay additional §2801 tax resulting from an "imperfect election." As with the election, the termination is effective for the entire year at issue. However, subsequent elections for a year in which a termination occurs are expressly allowed under §28.2801-5(d)(5)(iii). In addition, §28.2801-5(d)(6) outlines the procedure for disputes between the IRS and an EFT over the §2801 tax.

If a NEFT migrates and actually becomes a domestic trust, the trust must timely file a Form 708 for the year of migration and pay any §2801 tax due based on the same calculation as an EFT (i.e., on all covered transfers received by the trust during the year in which domestication occurs, as well as on the portion of the trust's value at the end of the year preceding the year of domestication attributable to all prior covered transfers). The filing must be made by the 15th day of the sixth month of the calendar year following the close of the calendar year in which the NEFT becomes a domestic trust.

Section 2801 Tax Responsibility. Section 28.2801-7(a) places the burden of ascertaining a taxpayer's obligations under the §2801 tax regime on the taxpayer, including determination of whether (1) the transferor is a CE and (2) a transfer is a covered transfer. The IRS has reserved the right to provide the taxpayer with information about the transferor to assist the taxpayer, which can only be relied on if the taxpayer has no knowledge or reason to know that such information is incorrect. Living expatriate donors who do not authorize disclosures to their U.S. recipients are deemed via rebuttable presumption to be CEs that have made a covered gift.

In limited circumstances, a taxpayer may file a protective Form 708 without payment to begin the §2801 tax assessment period if the taxpayer reasonably concludes after exercising due diligence that the transfer is not subject to the §2801 tax. The Proposed Regulations specifically advise that the mere absence of information is not a sufficient basis for a protective Form 708.

Escape From New York

As mentioned above, for New Yorkers, U.S. expatriation is only half the battle. Expatriates who are New York state, New York City, and/or Yonkers (collectively, NY) residents must also break NY residency and domicile, as an expatriate will remain generally[3] subject to NY income and estate taxes if he or she is either (1) a NY domiciliary or (2) maintains a permanent place of abode in NY for more than 11 months during the year and spends more than 183 days per year in NY.

Breaking NY residency will trigger a NY exit tax under NY Tax Law §639(a), which requires including in the NY resident period any gains, losses, deductions, or ordinary income portions of lump sum distributions not previously recognized under the taxpayer's method of accounting but which would be recognized in income under the accrual method of accounting on or before the last day of the residency period. The relative amounts of NY and federal exit taxes paid depends on the timing of expatriation and breaking of NY residency. A New Yorker who breaks NY residency and expatriates on the same date will pay federal and NY income taxes on the deemed sale of assets caused by the expatriation as that sale is treated as occurring on the day before the expatriation and so is treated as occurring during the residency period. A New Yorker who breaks NY residency prior to expatriating should not pay the NY exit tax on the deemed sale of assets caused by the expatriation, as those gains should not be treated as having accrued under the accrual method of accounting on or before breaking NY residency but of course will pay the federal exit tax on such deemed sale, i.e., gains that accrue before expatriation. A New Yorker who breaks NY residency after expatriating will not pay federal exit taxes on unrecognized gains accruing after the expatriation date but will pay NY exit tax on all such gains, to the extent they would be recognized under the accrual method of accounting on or before terminating NY residency.

Domicile: A New York State of Mind. Domicile is defined as the combination of physical presence in a place and the intent to remain there indefinitely. New York has a rigid set of auditing guidelines that are used to determine whether a person is a NY domiciliary.[4] The guidelines instruct the auditor to look first to four primary factors, then to a fifth secondary factor, and finally to a number of tertiary factors.

The first primary factor is the home; the auditor will evaluate and compare the use of any NY and non-NY residences. Second, the auditor will analyze any active business involvement, including patterns of employment, compensation sources, and active participation or substantial investment in NY businesses or entities. Third, the auditor will consider overall living patterns and time spent in NY. Fourth, the auditor will look to whether items "near and dear to the heart" are located in NY. If the first four factors are not dispositive, the location of close family members such as spouses and children are considered. Tertiary factors, considered only if a determination still cannot be made, include domicile citations in legal documents, primary mailing addresses for financial and family business correspondence, locations of safe deposit boxes, vehicle registrations and operator licenses, voter registration and history, parking tax exemptions, and telephone services.

Statutory Residency. An individual who is not a NY domiciliary will be considered to be a statutory NY resident (for income tax purposes) if they maintain a permanent place of abode (a PPA) in NY for more than 11 months during the year and spend more than 183 days per year in NY. A PPA is a permanent structure where a person can live year round, and includes residences owned or leased by spouses. Simply contributing toward expenses of a PPA can be considered residency-triggering maintenance. Spending a single minute in NY counts as a "day" for the 183-day rule, unless (1) travelling through NY to reach another destination or (2) a medical emergency requires presence in NY.

Exceptions. NY will apply the above statutory residency test without regard to any treaties or federal rules bearing on an expatriate's residency status for federal income tax purposes. However, because the starting point of NY taxation is federal gross income, an expatriate who under the IRC or a treaty is a nonresident alien for federal income tax purposes will not be subject to NY taxation on foreign source income.

A NY domiciliary will not be a NY resident if he or she falls under either of the following three-factor state law exceptions. To qualify for the first exception, the domiciliary must, (1) not have maintained a NY PPA during the year, (2) have maintained a non-NY PPA during the *entire* tax year and (3) have spent 30 days or less in NY during the tax year. To qualify for the second exception, the domiciliary must (1) be in a foreign country for at least 450 days during any 548 consecutive day period, (2) have spent 90 days or less in NY (spouses and minor children count as the domiciliary for this test), and (3) have spent no more days in NY than as permitted under the following formula:

Maximum Number of Days Allowed in NY=

$$90 \times \frac{\text{Number of Actual Foreign Days in 548 Day Period}}{548}$$

Conclusion

While the combination of hefty city, state, and federal taxes have many New Yorkers' vagabond shoes longing to stray, a "clumsy" expatriation will cause a big bite to be taken out of their big apple. Leave the concrete jungle with caution … and counsel!

1. Unless otherwise noted, all citations are to the Internal Revenue Code of 1986, as amended, and to currently Proposed Treasury Regulations promulgated thereunder.

2. It is anticipated that Treasury Regulations under § 2704 will be issued in the near future. Such regulations would likely impact the applicability of discount planning. A discussion of these regulations is beyond the scope of this article.

3. Note that a nonresident of NY will remain subject to NY income tax on any so called "NY source income" and a nonresident's estate will be subject to NY estate tax on any real or tangible personal property located in NY upon death. Similarly, a U.S. expatriate will still be subject to federal income tax on "U.S. source income" and such individual's estate will be subject to federal estate tax on any real or tangible personal property located in the United States upon death. Analysis of these situs-based rules is complex and beyond the scope of this article.

4. The guidelines are available at http://www.tax.ny.gov/pdf/2014/misc/nonresident_audit_guidelines_2014.pdf.