Thought Leadership Discussion

Valuation for the Expatriation Tax—"So Long, It's Been Good to Know Yuh"

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Expatriation involves the relinquishment of citizenship or the termination of long-term residency in your home country. When this event occurs, the home country, especially the United States, may levy a tax on the expatriating party. The current expatriation tax in the United States is a tax on the built-in accumulated unrealized gain on an expatriate's worldwide assets. Business and property valuations are often required to document the expatriating party's exit tax position. In addition, such valuations may be required to assist in establishing a new tax basis in the new country. This discussion summarizes the U.S. expatriation tax and related valuation matters for the expatriate.

Introduction

When an individual U.S. citizen or a foreign long-term resident (i.e., a non-citizen long-term U.S. lawful permanent resident, also known as a "green card holder") decides to give up the status of a citizen or a green card holder, he or she becomes "expatriates."

This act of giving up the citizen/resident status is known as "expatriation." This also means that the expatriated individual ceases to be a U.S. taxpayer.

But before an expatriate can sing, "So long, it's been good to know yuh,"[1] there is a final reckoning with the U.S. tax authorities.

When this status-changing event occurs, the U.S. levies a tax, one more time, on the expatriating party by taxing his or her worldwide assets. This expatriation tax (also called an "exit tax" or, more generally, an "emigration tax") and the related valuation issues are the subjects of this discussion.

This discussion does not address corporate expatriations (also known as "inversions") or corporate tax issues concerning offshore assets under the Tax Cuts and Jobs Act of 2017.

Origins of the Expatriation Tax in the United States

Although other countries also have an emigration tax,[2] the U.S. is one of the very few countries in the world that taxes its citizens on their worldwide income and assets. Most other countries follow a "residence-based" tax system for individuals. That system allows a country's citizens to be taxed under the tax laws of the country in which they reside or source their income.

However, the only way a U.S. citizen (or green card holder) can exit the "worldwide" U.S. tax system is to renounce his or her citizenship (or end his or her U.S. long-term[3] resident status as a green card holder).

In the years immediately following World War II, the top marginal income tax rates were as high as 91 percent, later falling to 70 percent during the Kennedy and Johnson administrations. As a result, a number of wealthy, high-earning U.S. citizens relinquished their citizenship and moved to other countries with much lower tax rates.

This procedure was often accomplished by people shortly before retirement and just before the sale of their very valuable and highly appreciated investments, such as private companies.

Such an activity was seen as unpatriotic by Congress during the 1960s, as such gains were accrued using the privileges and protections afforded to citizens of the United States. However, the taxes on such accumulated gains would not be collected by the United States if the citizen expatriated.

The issue of expatriation received renewed attention as the new century began. Many more U.S. citizens have been living abroad since 1999.[4] In recent years, the number of U.S. nationals and long-term residents renouncing their citizenship or residence has also increased significantly.[5]

A prominent example was Eduardo Saverin, a cofounder of Facebook, who renounced his U.S. citizenship in September 2011 and thereby avoided an estimated $700 million in U.S. capital gains taxes.

The primary driver of more recent renunciations has been the financial difficulties that American taxpayers living abroad face in the wake of the U.S. Foreign Account Tax Compliance Act ("FATCA") regulations. This regime burdens U.S. taxpayers holding non-U.S. assets with extensive reporting requirements to the U.S. Internal Revenue Service (the "Service") and forces financial institutions with American clients to report to the Service as well.

Many foreign financial institutions will not do business with individual U.S. taxpayers or their controlled entities because of the complexities, uncertainties, and penalties under FATCA.

The first law to authorize exit taxation of tax-motivated expatriates was passed in 1966, creating Internal Revenue Code Section 877. Section 877 was amended in 1996 and again in 2004. The current law on expatriation taxation dates to June 17, 2008, when a new Section 877A was created under the Heroes Earnings Assistance and Relief Tax Act.

In essence, the current expatriation tax in effect since 2008 is a tax on the built-in accumulated unrealized gain on an expatriate's worldwide assets.

Who Is Liable for Paying the Expatriation Tax?

Although certain reporting requirements fall on all expatriates, the Section 877A exit tax rules apply to the following type of wealthier expatriates:

- Those with average annual net income tax payments in excess of $165,000[6] for the five years ending before their date of expatriation (i.e., the date of relinquishment of citizenship or date of termination of long-term residency)
- Those with a net worth of $2 million[7] or more on the date of expatriation
- Those who have failed to certify that they have complied with all U.S. federal tax obligations for the five years preceding the date of expatriation (including filing all required tax forms)

If any one of these three tests apply, then the person is considered a "covered expatriate." These covered expatriates face increased disclosures to the Service and have to calculate their expatriation tax.

Valuation Standards for Calculating Reported Asset Values

How to Decide What Assets Are Included for Expatriation Tax Issues

For purposes of the net worth test and the calculation of the expatriation tax, all assets include "any interests in property" that would be considered part of the covered expatriate's estate or taxable as a gift, if such death[8] or gift occurred as of the day before the expatriation date.[9]

This interest includes the right to use property, as well as the ownership of property.

There are two basic classifications of assets for expatriation tax issues.

The first category is "gains assets." These gains assets are the typical investment property (including private business interests) and other personal and real property owned by individuals that could be expected to grow in value while an expatriate was living in the United States. Taxpayers typically pay capital gains taxes when they sell such assets.

In addition to gains assets, the second asset classification category consists of three other groups[10] of assets subject to the expatriation tax rules. Therefore, these assets are also included as part of the $2 million net worth test and are recognized as exit tax income items, as follows:

- Deferred compensation items (e.g., pensions, annuities, deferred items of compensation—whether substantively vested or not)
- Specified tax deferred accounts (e.g., IRAs)
- Beneficiary interests in a nongrantor trust

Deferred compensation items come in two varieties: eligible and ineligible.

An eligible deferred compensation item is taxed when distributions are made to the expatriate and taxed on a withholding tax basis, as discussed further below.

An ineligible deferred compensation item is generally treated as if the expatriate received the account in a lump sum payment the day before the expatriation date.

Mark-to-Market Valuation Regime for Gains Assets

The value of each interest in property is determined on a "mark-to-market regime." As mentioned, these gains assets are deemed to have been sold or valued for transfer tax (i.e., gift and estate tax) purposes as of the day before the expatriation date.

Therefore, the standard of value used for calculating the expatriation tax starts (but doesn't end) with fair market value as defined under the Code and the regulations for estate and gift tax purposes. Fair market value in this context is defined as: "the price at which such property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell, and both having reasonable knowledge of relevant facts."[11]

The details of how to apply this standard are set forth in the regulations for determining gift and estate taxes.

However, the Service also indicates in Notice 2009-85 that certain valuation treatments allowed for estate and gift tax purposes should be altered or ignored for expatriation tax purposes. Favorable income tax treatment that might apply to certain types of assets are also altered or ignored. A number of examples of this changed valuation treatment are discussed further below.

One, the Service claims that fair market value should be determined as if the covered expatriate's interests were being transferred to family members, so that the discount-reducing provisions in Chapter 14, Sections 2701 through 2704, would apply.

Two, the exit tax rules do not allow the use of the alternate valuation date or the special use farm land valuation rules available for estate taxes.

Three, Section 121 allows a taxpayer a $250,000 exclusion on the sale of his personal residence. However, under the Section 877A expatriation tax, this favorable income tax provision is ignored in calculating the built-in gain on a residence.

As a result of these alterations, the standard of value used in expatriation tax matters is a modified fair market value standard.

Valuing the Second Classification Category of Assets

The "other groups" of interests under Section 877A(c) are valued in a similar fashion, using fair market value concepts under the gift and estate tax rules. Deferred compensation items such as pensions are typically valued on the basis of the present value of the estimated stream of accrued benefits as of the day before the expatriation date.[12]

Specified tax deferred accounts, such as IRAs, are valued based on their account balances. Beneficiary interests in nongrantor trusts are valued based on the expatriate's allocable share of the trust account's balance.[13]

Therefore, both of the last two groups use the modified fair market value standard discussed above, based on estate and gift tax valuation principles, since determination of account balances depends on the fair market values of the account's underlying asset values. A covered expatriate's interest in an insurance policy is valued under the gift tax regulations set forth in Regulation 25.2512-6.

Reporting and Justifying Fair Market Values

Form 8854 includes a balance sheet disclosure schedule that the covered expatriates have to fill out. All assets and liabilities are required to be listed "in U.S. dollars (at) the fair market value."[14]

The form is submitted "under penalties of perjury" and the covered expatriate declares that the schedules and statements submitted "to the best of my knowledge and belief (are) . . . true, correct, and complete."[15]

Covered expatriates must report values using "good faith estimates of values" but "formal appraisals are not required."[16]

Because of the lack of regulations in this area, it is unclear whether the taxpayer has a duty of "adequate disclosure" as he or she does for transfer tax reporting purposes. Since the expatriation tax valuation rules are taken from transfer tax valuation regulations, it is reasonable to assume that adequate disclosure of the valuation positions taken would be necessary in order to ensure that an expatriation tax filing on Form 8854 was "true, correct, and complete."

Furthermore, although Section 877A has been in existence for over 10 years now, the Service has never promulgated any regulations interpreting its valuation rules or other issues.[17]

Likewise, there are no court cases that substantively address valuation or other issues under Section 877A. The last court case to address any significant expatriation tax issues was decided in 1984.[18]

Even though formal appraisals are not required, they are useful for documenting the valuation reasoning and confirming that a value estimate was made in good faith and not by blind guesswork or by applying incorrect facts and analysis that amount to perjury.

In summary, the rules for the valuation of assets for the net worth test and for the calculation of the expatriation tax are a mash-up of both income tax principles and transfer tax principles and are not well supported by regulations, instructions, or court cases. These rules may appear simple at first glance, but actually they can be difficult to interpret and execute.

The Current Rules for Taxing Covered Expatriates

As of 2018, the expatriation tax is calculated in the following manner:[19]

1. Calculate the value of all of the covered expatriate's worldwide net assets (there are some exceptions) and assume these gains assets were sold as of the day before the date of expatriation
2. Calculate the built-in gain (or loss) for each asset by subtracting the assets' adjusted tax basis (there are some special rules on developing this basis for the expatriation tax)[20] from the value of the asset[21]
3. Subtract an "exclusion amount" of $713,000 (this amount is adjusted annually for inflation) as a deduction from the net built-in gains, allocating this amount pro rata among the assets with gains
4. Apply the appropriate tax rate (for capital gains, the top marginal rate is currently 23.8 percent) to the net gains left, if any, after the exclusion amount deduction

The exclusion only applies to gains assets. Therefore, the exclusion will not shelter income calculated on the acceleration of income recognition from deferred compensation items, specified tax-deferred accounts, and beneficial interests in nongrantor trusts—the other categories of assets discussed above.

These particular other groups of assets are either taxed when the covered expatriate receives distributions in a relevant future tax year[22] or included as income for the year in which the date of expatriation occurs.[23]

Withholding taxes of 30 percent are applied to future distributions. This typically applies to eligible deferred compensation items and beneficiary interests in nongrantor trusts. In other cases, however, the entire lump sum of an interest can be taxed immediately, particularly if a withholding tax notification[24] deadline is missed. Specified tax deferred accounts (like IRAs) and ineligible deferred compensation items are taxed as if received as a lump sum.

All expatriates are required to file Form 8854 with the Service. Covered expatriates must report to the Service their expatriation tax information on a section of Form 8854 and attach it to their annual income tax form (typically Form 1040) that they file to report and pay income (including expatriation) taxes for the year in which the date of expatriation occurs.

The covered expatriate can elect to defer the expatriation tax due for gains assets on a property-by-property basis until each asset is sold. But there are rigorous requirements to post security in the form of a bond or letter of credit to cover the tax owed and continuing requirements to file an annual Form 8854 in order for the Service to track that the expatriation taxes are eventually paid.

Interest at the underpayment rate (Section 6621) will also accrue on the deferred expatriation tax balance. It is rarely worth deferring payment due to the burdens of continuing compliance complexities and interest payments.

Valuation Planning for the Expatriation Tax

Valuation planning for minimizing the expatriation tax is based on the similar principles of minimizing transfer taxes through standard estate planning techniques.

First, individuals should consider fully utilizing their annual and lifetime transfer tax exemptions prior to expatriation in order to reduce their net worth. The individual exemption amount was $11.18 million for 2018 and is $11.40 million for 2019. This alone could reduce an affluent expatriate's net worth below the $2 million threshold to lawfully avoid becoming a covered expatriate.

Second, individuals anticipating expatriation should create fractionalized ownership interests in privately held businesses that are eligible for discounts for lack of control and for lack of marketability. Such ownership configurations can reduce net worth and lower the expatriation tax. However, this requires careful consideration of the Service's alteration of the fair market value rules applicable for estate and gift taxes as discussed previously.

Third, assets can be sold to relatives in exchange for notes at the applicable federal rate ("AFR"). The current AFR is typically below fair market value rates of interest. This allows notes to be discounted from their face value to lower fair market values for expatriation tax reporting purposes.

Some asset sales could also be considered before expatriation because of more favorable tax treatment under the regular income tax provisions of the Service, rather than subject them to exit tax treatment under Section 877A which can ignore some of these favorable provisions.

Other estate and gift planning techniques involving trusts and other transactions not directly involving valuation matters can also be useful.

Expert legal, accounting, and valuation advice is often necessary to avoid problems. Willamette Management Associates has been involved in developing valuation opinions for these expatriation valuation issues for planning and exit tax reporting compliance purposes, so feel free to consult with us.

Examples of Some Typical Client Situations

The Green Card Holder

Juan, a citizen of a South American country, has been operating his business interests in the United States for many years and obtained a green card while working for a U.S. public company early in his career. He is nearing retirement age and has interests back in his home country and elsewhere. These include a home country business co-owned with his brother.

He also owns interests in private equity companies and investments in hedge funds domiciled in Europe.

The Child Immigrant

Ivan was brought to America as a child and became a naturalized U.S. citizen. His parents were fleeing a tyrannical regime in his home country. He grew up in the United States, attended college here, and became a very successful businessman. Most of his investment interests and business activities have shifted to other countries as far away as in Asia. His parents still reside in the United States.

Because of a regime change and a resurgence in free markets and democracy in his homeland, he is considering expatriation back to his native land or to another country with a favorable tax and business climate.

The Birth Citizen

John was born in the United States. He is proficient with several languages and worked in many countries around the world. He met and married his wife in her native country while on a work project.

He is now active in businesses and investments on his own and with members of his wife's family in the region around her home country where they live. Because of continuing FATCA difficulties, he is considering expatriation to his wife's homeland. He and his siblings are also beneficiaries of a trust set up by his grandparents who are U.S. citizens.

Summary and Conclusion

Expatriation involves relinquishment of citizenship or termination of long-term residency in the U.S. As a result of this status-changing event, the U.S. levies a tax on the expatriating party's worldwide assets. The current expatriation tax is a tax on the built-in accumulated unrealized gain on an expatriate's worldwide assets.

The expatriation tax rules apply to certain wealthy covered expatriates, typically individuals with a net worth in excess of $2 million. These covered expatriates bear a greater expatriation tax reporting burden and will have to pay the exit tax if their net gains and resulting income items are in excess of the current exclusion amount of $713,000.

The assets and liabilities included in the exit tax calculation are valued on a mark-to-market regime. This regime is based on a modified version of the fair market value standard set forth in the transfer tax statutes and regulations (i.e., the valuation rules for gift and estate tax purposes).

The rules for the valuation of assets for the net worth test and for the calculation of the expatriation tax are a mash-up of both income tax principles and transfer tax principles and are not well supported by regulations or court cases.

Although formal valuations are not required to support the taxpayer's valuation positions, they are useful in establishing that the estimated values were made in good faith and reported in a true, correct, and complete fashion.

Willamette Management Associates has been involved in developing valuation opinions for these valuation issues over many years for expatriation planning and exit tax reporting compliance purposes, so feel free to consult with us. We want you to be able to tell the Service: "so long, it's been good to know yuh!"

Notes:

1. The song "So Long, It's Been Good to Know Yuh" was written and recorded by Woody Guthrie on his album *Dust Bowl Ballads* (1935).
2. For example, Canada imposes a "departure tax" on parties who cease to be a tax resident in that country.
3. "Long-term" for expatriation tax purposes is defined as living as a lawful permanent resident in the United States at least 8 out the 15 taxable years prior to the expatriation date taxable year.
4. The U.S. State Department estimated that approximately 9 million nonmilitary Americans were living abroad in 2016, compared to only 4 million in 1999.
5. Prior to 2000, fewer than 1,000 people per year typically became expatriates. Since 2012, over 3,000 people per year relinquish their citizenship or green card status and expatriate, according to the Service.
6. This amount is adjusted annually for inflation. The amount shown is for 2018.
7. This amount is fixed and not adjusted for inflation.
8. Perhaps the expatriation tax is Uncle Sam's way of saying, as Don Vito Corleone might say: "You are dead to me."
9. IRS Notice 2009-85, also referencing Service Notice 97-19, 1997-1 C.B. 394.
10. As described in Section 877A(e).
11. 26 CFR Section 25.2512-1, concerning gift taxes.
12. Notice 2009-85, Section 5(D).
13. Notice 97-19, Section III.
14. Form 8854 (2018), page 5.
15. Ibid., 6.
16. Notice 97-19, Section III.
17. IRS Notices do not have the force and effect of regulations and are accorded no more weight than this discussion or any other expert's opinion.
18. See Furstenberg v. Commissioner, 83 T.C. 755 (1984).
19. www.IRS.gov/Form8854
20. Issues regarding the calculation of cost basis for expatriation taxes are beyond the intended scope of this discussion.
21. The deemed gain for each asset retains its original character: long-term capital gains, ordinary income gains, etc.
22. These are called "eligible deferred compensation items."
23. These are called "ineligible deferred compensation items."
24. Via Form W-8CE.

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