



Perspectives April 2024



Nastco / istockphoto.com

THE EXPATRIATION TAX: HOW TO PRESENT ASSETS TO THE IRS WHEN YOU SAY GOODBYE TO THE UNITED STATES

By **Samuel S. Nicholls** | Director, Atlanta

Longtime U.S. residents who wish to leave the country as a permanent resident might be subject to the expatriation tax. There are important considerations regarding the valuation of assets that are reported to the Internal Revenue Service (“IRS”). The value of those assets affects the level of tax that is paid. In addition to retaining appropriate legal and tax counsel, for certain types of assets—stock or limited partnership interests, real property, and fine art and gems—enlisting the services of a credentialed appraiser, otherwise known as a valuation analyst, may be advisable for reporting the assets’ estimated value on IRS Form 8854.

Introduction

In 2008, Congress enacted Internal Revenue Code (“IRC” or the “Code”) 877A, which imposes a tax on individuals who leave the U.S. as permanent residents if their income or net worth exceeds certain levels. This is known as an “expatriation tax” (or “exit tax”). The federal government imposes the expatriation tax not just on U.S. citizens, but also on any long-term resident of the U.S., such as a green card holder, if they have been a permanent resident for at least 8 of the previous 15 years.¹

Expatriating individuals subject to the tax are referred to by the Internal Revenue Service (“IRS”) as “covered expatriates,” defined as those who generated income exceeding a certain level for the past five years or had a net worth exceeding a certain level as of the day before the expatriation date.

“I LEFT THE WOODS FOR AS GOOD A REASON AS I WENT THERE. PERHAPS IT WAS BECAUSE I HAD LIVED THERE LONG ENOUGH.”

— HENRY DAVID THOREAU

As published on the IRS website, the income threshold after which one is subject to the expatriation tax is the average of the five preceding years, adjusted for inflation each year, with the 2017 level at \$162,000, ratcheting up to \$201,000 in 2024. The net worth threshold is \$2 million.

What to Do if Subject to This Tax

Individuals planning to leave the U.S. should consult



with legal counsel and a tax advisor experienced with assisting soon-to-be expatriates.

IRS Form 8854—Initial and Annual Expatriation Statement—is required to be submitted by individuals who want to expatriate. As of 2023, this form was five pages long and included such entries as where the expatriate will live and can be reached after leaving the U.S., citizenship or resident status, taxable income in each of the prior five years, net worth, and a balance sheet for assets listed at “fair market value.”

For assets subject to the expatriation tax, adherence to IRC 877A’s “mark-to-market” standards is required. An asset’s estimated fair market value is to presuppose that it was sold on the day before the expatriation date. The following is excerpted from the IRS website:

Any gain arising from the deemed sale is taken into account for the tax year of the deemed sale notwithstanding any other provisions of the Code. Any loss from the deemed sale is taken into account for the tax year of the deemed sale to the extent otherwise provided in the Code, except that the wash sale rules of IRC 1091 do not apply. The amount that would otherwise be includible in gross income by reason of the deemed sale rule is reduced (but not to below zero) by \$600,000, which amount is to be adjusted for inflation for calendar years after 2008 (the “exclusion amount”).

For calendar year 2024, the exclusion amount is \$866,000.

The form is submitted “under penalties of perjury,” and the covered expatriate is required to declare that the schedules and statements “to the best of my knowledge and belief [are] true, correct, and complete.”²

Declaration of the Fair Market Value of Claimed Assets

In the case of assets whose value is readily available, such as securities that trade on a public exchange, the fair market value ordinarily is based on their per share trading price. There are exceptions, such as thinly traded publicly traded stock that may be eligible for a valuation discount. In the case of illiquid assets whose value is not readily transparent, such as shares in a privately

held company, the fair market value may have to be estimated by a professional appraiser—unless there have been recent, arm’s-length transactions in the same class of security that one could point to as an indication of value as of the expatriation date.

For purposes of estate and gift taxes, the Treasury Regulations of the IRC define fair market value as the price at which the subject property would change hands between a hypothetical willing buyer and a hypothetical willing seller, with both having reasonable knowledge of all relevant facts and neither party being under any compulsion to buy or sell. For expatriation purposes, the IRS specifically points to IRC Section 2031 regarding the definition of a gross estate, which contains the same language as described in the regulations.

FOR ASSETS SUBJECT TO THE EXPATRIATION TAX, ADHERENCE TO IRC 877A’S “MARK-TO-MARKET” STANDARDS IS REQUIRED.

Assets May Be Eligible for Valuation Discounts

It may be appropriate to apply a valuation adjustment—a discount for lack of liquidity or discount for lack of marketability (“DLOM”)—to certain assets held by an expatriating individual. These include:

- Public Equity – Restricted stock in a publicly traded company, stock in a publicly traded company that is thinly traded, or a block of stock in a company that is publicly traded but the holding’s size relative to weekly volumes indicates it is not entirely liquid
- Private Equity Funds – Limited partnership holdings in private equity funds and hedge funds (as evidenced by empirical data, a hypothetical willing buyer and hypothetical willing seller may transact in the secondary market at a discount to net asset value³)
- Privately Held Operating Companies – Noncontrolling (minority) ownership interests and, if appropriate, controlling ownership interests in a privately held operating company.



anyaberkut / istockphoto.com

Numerous judicial decisions have affirmed the application of a DLOM to the valuation of a controlling ownership interest.⁴ It may take months (or even years) to complete the offering or sale of the private company controlling block of stock. This uncertain (but considerable) time horizon contrasts with the principle of marketability. The principle of marketability implies a short sale conversion period.

- Privately Held Holding Companies – Shares or units held in a private holding company whose main assets are passive investments of liquid publicly traded stock or less liquid assets, such as real estate properties, fine art, or hedge fund interests
- Real Estate Property – Ownership interests in timberland or land with oil reserves or undivided interests in real estate property (tenants-in-common)
- Contracts – Rights to future income streams, such as a perpetual commission payout from past services with a multilevel marketing company

When appropriate, the magnitude of adjustments applied to arrive at the fair market value of an asset depends on the facts and circumstances of each case. There is no magic formula for applying a discrete

percentage discount for any class of asset. Although certain quantitative models, discussed later, may be appropriate in certain circumstances and will arrive at a discrete indication (or a range) of discount, a degree of judgment and discretion on the part of the valuation analyst still is required when analyzing data that go into any model.

Valuation Discounts for Stock in Publicly Traded Companies

Marketability discounts may apply not only to holdings in private companies, but also to holdings in publicly traded companies. If the expatriating individual holds a large block of publicly traded stock and selling the entire block in a short period could affect the stock price, the market could not otherwise absorb the entire block, or the stock is restricted (such as held by an insider), it is possible that a DLOM⁵ could be applied to the prevailing market price.

The magnitude of the discount can vary widely and is typically (1) lower for freely tradeable stock that nonetheless would have to be “dribbled out” in batch sales over a few months because the stock is thinly traded, (2) higher for restricted stock that has a longer holding period per Securities and Exchange Commission Rule 144, and (3) even higher for occasional circumstances where company insiders have additional restrictions (such as after an initial public offering).



Option Pricing Models to Estimate the DLOM

An option pricing model (“OPM”) for estimating a DLOM can be useful when there is a known holding period during which an asset is restricted from sale. One of the inputs for the Black-Scholes OPM is, in fact, the duration of the holding period. Not only may the holding period be applicable for restricted securities, but it also may be applicable for limited partner interests in hedge funds that invest in publicly traded stock. That is because funds often require advance notice (sometimes up to a year) before one can redeem their interest.

Another input for the Black-Scholes OPM is selected volatility based on volatility statistics drawn from other companies—guideline publicly traded securities—unless the subject company itself is publicly traded. Selecting appropriate guideline companies that are reasonably comparable to the subject private company and analyzing their security’s volatility statistics are an important part of the process.

IN THE CASE OF RESTRICTED OR THINLY TRADED PUBLICLY TRADED STOCK THAT MAY NOT BE FEASIBLE TO SELL ALL AT ONCE, THE DRIBBLE-OUT MODEL MAY BE EMPLOYED TO ARRIVE AT THE PRESENT VALUE OF FUTURE PROJECTED BLOCK SALES.

In certain cases, such as for an executive of a company that recently went public, the analysis to arrive at an appropriate valuation adjustment may include the hypothetical purchase of several put options (i.e., options to sell the underlying security), one for each block of stock until its restricted period expires. The cost of the put option per share or unit is divided by the security’s undiscounted price per share or unit for an indication of an appropriate percentage discount for the subject interest.

OPMs are based on the principle that the cost to purchase a stock option is related to the DLOM. David

Chaffee authored a 1993 study, concluding that “if one holds restricted or non-marketable stock and purchases an option to sell those shares at the free market price, the holder has, in effect, purchased marketability for those shares. The price of that put is the discount for lack of marketability.”⁶

OPMs are driven largely by the holding period and historical volatility, but other factors that are not included in an OPM’s inputs might affect marketability. As stated in *Best Practices: Thought Leadership in Valuation, Damages, and Transfer Price Analysis*, “OPM studies may understate the measurement of the DLOM” as they “ignore other factors that may reduce the marketability for closely held company securities (e.g., contractual transferability restrictions).”⁷

Other than contractual restrictions on sales, company-specific factors can affect the marketability of a holding. For example, the McConaughy, Cary, and Chen restricted stock study indicates, “There are three factors that remain significant: size, stability of revenue growth, and stock price volatility. These three factors clearly reflect the riskiness of investing in a company.”⁸ A large company is a “safer” investment than a similar small company, all other factors being equal. This conclusion is illustrated by comparing the expected rates of return of large-capitalization companies with those of small-capitalization companies. Ibbotson Associates makes this comparison:

*One of the most remarkable discoveries of modern finance is the finding of a relationship between company size and return. . . . The relationship between company size and return cuts across the entire size spectrum. . . . Small-cap stocks are still considered riskier investments than large-cap stocks. Investors require an additional reward, in the form of additional return, to take on the added risk of an investment in small-cap stocks.”*⁹

In the case of restricted or thinly traded publicly traded stock that may not be feasible to sell all at once, the dribble-out model may be employed to arrive at the present value of future projected block sales. The difference between the present value of future block sales and the present value if the holding was liquid and could be sold expeditiously sometimes is referred to as a “blockage discount.”



Blockage Discounts

Blockage discounts may be estimated by applying the dribble-out model, which has been accepted by the U.S. Tax Court (the “Tax Court”). For example, in *Gimbel v. Commissioner*,¹⁰ the Tax Court held that Georgina Gimbel’s restricted shares in a publicly traded company could be liquidated by selling the shares over time, using the cost of equity capital as the discount rate, concluding that the discount associated with blockage can be estimated by applying the dribble-out model. Even if the subject block is not restricted but its size exceeds the historical average daily trading volume by such an amount that it would have to be sold over the course of time, the dribble-out model may be appropriate to estimate a valuation discount.

The procedures when applying the dribble-out model involve analyzing historical trading volumes of the publicly traded security subject to the analysis. The size of the subject block is compared with the historical average trading volume. The next step is to estimate the anticipated holding period—the expected length of time required to sell a subject interest. The model then is constructed as a hypothetical sale in smaller blocks over weeks or even more than a year, with each block sale discounted to present value.

About the Author



Samuel S. Nicholls is a director of our firm. He can be reached at (404) 475-2311 or at ssnicholls@willamette.com.



Conclusion

The expatriation tax is imposed not just on expatriating U.S. citizens, but also on any long-term resident of the U.S.¹¹ IRS Form 8854 includes a personal balance sheet to be filled out, 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.”¹²

Declaring the value of one’s assets and liabilities may be simple in some circumstances, but in other cases, it may call for a professional estimate.



To receive our quarterly *Perspectives* directly to your inbox, visit:
<https://willamette.com/resources/subscribe.html>

The opinions and materials contained herein do not necessarily reflect the opinions and beliefs of the author’s employer. In authoring this discussion, neither the author nor Willamette Management Associates, a Citizens company, is undertaking to provide any legal, accounting, or tax advice in connection with this discussion. Any party receiving this discussion must rely on its own legal counsel, accountants, and other similar expert advisors for legal, accounting, tax, and other similar advice relating to the subject matter of this discussion.

©2024 Citizens Financial Group, Inc. All rights reserved. Willamette Management Associates, a Citizens Company is a brand name of Citizens Financial Group, Inc.



References:

- 1 There are certain exceptions, as specified by Section 877A(g)(1)(B), such as having dual citizenship and being taxed as a resident in the other country.
- 2 IRS Form 8854 (2023), 5.
- 3 There are exceptions. A secondary transaction in a private equity fund may command a premium to net asset value, such as for a fund that is highly coveted by interested investors due to historical performance but difficult for interested investors to find a selling limited partner.
- 4 See, for example: Estate of Dunn v. Commissioner, T.C. Memo 2000-12 (January 12, 2000); Estate of Jameson v. Commissioner, T.C. Memo 1999-43 (February 9, 1999); Estate of Dougherty v. Commissioner, T.C. Memo 1990-274 (May 31, 1990); and Estate of Maggos v. Commissioner, T.C. Memo 2000-129 (April 11, 2000).
- 5 The terms “marketability” and “liquidity” are sometimes used interchangeably, per Robert F. Reilly and Robert P. Schweihs, *Best Practices: Thought Leadership in Valuation, Damages, and Transfer Price Analysis*, Valuation Products and Services, LLC (2019): 258.
- 6 David B.H. Chaffe III, “Option Pricing as a Proxy for Discount for Lack of Marketability in Private Company Valuations,” *Business Valuation Review* (December 1993): 182-86
- 7 Reilly and Schweihs, *Best Practices*: 273-74
- 8 Daniel L. McConaughy, David Cary, and Chao Chen, “Factors Affecting Discounts on Restricted Stock,” *Valuation Strategies* (November/December 2000): 46.
- 9 *Ibbotson SBBI 2015 Classic Yearbook* (Chicago: Morningstar, 2015), 99, 113.
- 10 Estate of Gimbel v. Commissioner, T.C. Memo 2006-270 (December 19, 2006).
- 11 Certain exceptions are specified by Section 877A(g)(1)(B).
- 12 Form 8854 (2023), 5.