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To Our Clients and Friends:

Re: Immediate Action Would Avoid Proposed Exit Tax on Expatriation

As the Senate and the House of Representatives wrangle over whether legislation increasing the federal minimum wage will include tax relief for small business, we write to bring to your attention a little-publicized "revenue offset" in the tax relief bill that the Senate Finance Committee has approved (the "Senate Bill"). If enacted, this provision would impose an exit tax on U.S. citizens who relinquish their U.S. citizenship ("former citizens") and certain long-term U.S. green-card holders who relinquish their green cards ("former residents"), in either case on or after the date the legislation is enacted. The exit tax would be equal to the federal income tax that would have been imposed had the former citizen or former resident sold for fair market value all of his or her worldwide assets at the time of expatriation. While it is not at all clear that the provision will be enacted in its present form, it may well be prudent for certain U.S. citizens and long-term green-card holders who are otherwise considering expatriation in the near future to take immediate action to relinquish their U.S. citizenship or green cards, so as to avoid the application of the exit tax should the new legislation be enacted.

The following is a very general description of the current tax law applicable to expatriates and the provisions of the Senate Bill that, if enacted, would replace the current law:

**Current Law.** A former citizen or resident (an "expatriate") meeting certain federal income tax and net worth thresholds is subject to the following special tax rules (in addition to the tax rules that otherwise apply to nonresident aliens): (i) the expatriate remains subject to U.S. federal income tax for 10 years after expatriation on certain types of U.S.-source income that otherwise would not be subject to U.S. tax in the hands of a nonresident alien, including gain on the sale of certain U.S.-situs personal property such as securities issued by U.S. corporations; (ii) were the expatriate to die within 10 years after expatriation, U.S. estate tax would apply not only to his or her U.S.-situs property but also to stock of certain closely held non-U.S. corporations to the extent they own U.S.-situs property; (iii) the expatriate is subject to U.S. gift tax on gifts during the 10-year period not only of U.S.-situs tangible property but also of U.S.-situs intangibles and the stock of certain closely held non-U.S. corporations to the extent they own U.S.-situs property; and (iv) if the expatriate spends more than 30 days in the U.S. in any of the 10 years after expatriation, he or she is treated as a U.S. citizen or resident, as the case may be, for that year, with the result that the expatriate's worldwide income for such year is subject to federal income tax, his or her worldwide gifts during such year are subject to U.S. gift tax and, were the expatriate to die in that year, his or her worldwide assets would be subject to U.S. estate tax. Under current law, gifts made by an expatriate, as well as gifts in general, are not subject to federal income tax in the hands of the recipient.

**The Senate Bill.** If the Senate Bill were enacted in its current form, with certain exceptions not generally applicable, a U.S. citizen or long-term green-card holder who gives up his or her U.S. citizenship or green card on or after the date of enactment (a “covered expatriate”) would be subject to the following rules in lieu of the above rules:

1. The covered expatriate would be deemed to have sold all of his or her worldwide assets owned on the date of expatriation (the “covered assets”) for their fair market value and would be subject to federal income tax on the net gain on such deemed sale to the extent it exceeds \$600,000 (the “exit tax”). For this purpose, U.S. real property interests would not be included in the deemed sale (because nonresident aliens are subject to U.S. tax on their gains from the sale of such assets), and special rules would apply to compute the exit tax payable on a covered expatriate’s interests in trusts, pension plans, IRAs, 401(k) plans and other retirement plans. Under the Senate Bill, a covered expatriate could avoid the current imposition of exit tax by electing either: (a) to be treated as a U.S. citizen in respect of *all* covered assets, in which case any gain on later sales of covered assets would be subject to federal income tax, any later gifts of covered assets would be subject to U.S. gift tax and the covered assets would be included in the covered expatriate’s gross estate for U.S. estate tax purposes, or (b) to defer the exit tax (and to pay interest on the deferral at 5 points over the U.S. Treasury rate) in respect of some or all of the covered assets until such time as such assets are sold (or, if earlier, the death of the expatriate). Either of these elections would require the covered expatriate to post security with the IRS.

2. In addition, any U.S. person receiving property as a gift or inheritance from a covered expatriate at any time after the expatriation date would be subject to federal income tax on the value of the property received, except to the extent the transfer is reported on a U.S. gift or estate tax return or is small enough to be exempt from gift tax reporting.

**Observations.** We have a number of preliminary observations on the proposed legislation:

1. Legislation similar to the Senate Bill has been introduced in Congress on several occasions, and has been passed by the Senate at least twice, only to be rejected by the House of Representatives and deleted from the final legislation. It is of course certainly possible that the same fate will befall the Senate Bill.

2. There can be no certainty, however, that the Senate Bill will not be enacted, particularly in light of the desire on the part of both houses of Congress to enact minimum wage legislation, the Senate’s apparent unwillingness to do so without also enacting at least some of the tax provisions contained in the Senate Bill and the possibility that, even if the expatriation provisions are not included in the minimum wage legislation, they could be added as a revenue offset to other spending or tax legislation. Since the Senate Bill would apply the exit tax only to those giving up their citizenship or green card on or after the enactment date (*i.e.*, the date the legislation is either signed by the President or enacted by Congress over the President’s veto), an individual who may otherwise be considering giving up his or her U.S. citizenship or green card and who holds substantially appreciated non-U.S. assets, is a beneficiary of one or more non-U.S. trusts or is a participant in a pension plan, IRA or 401(k) plan may well wish to

consider doing so immediately, to ensure that the expatriation occurs before the enactment date. Were the Senate Bill to be enacted in its current form, an individual who expatriated before its effective date would have avoided the exit tax, and would be subject to the 10-year income, gift and estate tax rules described above under "Current Law" (including the adverse consequences described above were the individual to be present in the U.S. for more than 30 days during the 10-year period). Note, however, that the individual would continue to be subject to U.S. income tax on his or her worldwide income (and, in the case of a former citizen, full U.S. estate and gift tax) until he or she met certain reporting obligations.

3. As noted above, special, and somewhat complex, rules would apply to trust interests held by a covered expatriate. Very generally speaking, these rules would not apply the exit tax to a covered expatriate's interest in a trust that has U.S. trustees and is subject to the laws of one of the United States (a "U.S. trust"), but rather would tax distributions from a U.S. trust to the covered expatriate (capped at the exit tax that would otherwise have been imposed on the expatriate's share of the trust's assets plus an interest charge), apparently even if the trust itself had in the meantime paid U.S. income tax upon its realization of gains that were subject to the exit tax. By contrast, the exit tax would apply to a covered expatriate's interest in a non-U.S. trust on the basis of a deemed sale of the expatriate's share of the trust's assets for their fair market value and a deemed distribution of the proceeds to the expatriate. Under the Senate Bill, different rules would apply for determining a covered expatriate's interest in U.S. and non-U.S. trusts for this purpose.

4. The Senate Bill would also amend the immigration laws to deny a covered expatriate who is a former citizen re-entry into the United States if he or she is not in compliance with the new expatriation rules. This provision would apply only to covered expatriates who have relinquished citizenship, and not to covered expatriates who have relinquished their green cards. While the provision contemplates that the IRS would provide the immigration authorities with information regarding whether an individual is in compliance with these rules, in the absence of implementing regulations it is unclear how the immigration authorities and the IRS would administer this provision or what procedural safeguards would be provided.

5. In connection with their change of status, individuals considering expatriation should consider not only the U.S. income, gift and estate tax implications but also the tax rules applicable in the individual's country of residence. It should be noted in this connection that, since it is very unlikely that other countries would allow a credit for the exit tax, covered expatriates may well face double taxation on gains subsequently realized on the sale of covered assets.

Please let us know if you wish to discuss the Senate Bill and the relevant considerations regarding expatriation in greater detail.

**To ensure compliance with the standards of U.S. tax practice to which we are subject, we are constrained as a practical matter to advise any recipient of this communication that, except as otherwise specifically stated herein, this communication is not intended as advice of a type which may be relied upon, and, therefore, may not be relied upon, for the purpose of avoiding penalties which may be imposed pursuant to U.S. tax law.**