

Tax and Trusts & Estates Update

"HEROES ACT" SLATED TO INCREASE TAX BURDEN ON U.S. EXPATRIATES

The Heroes Earnings Assistance and Relief Tax Act of 2008 (the "Heroes Act") is pending signature by the President, having been passed unanimously in both the House and the Senate. The Heroes Act will change materially the manner and the extent to which the U.S. taxes certain citizens and long-term lawful permanent residents (U.S. "green card" holders for at least eight of the previous 15 years) who expatriate after its effective date ("Covered Expatriates"). "Covered Expatriates" are generally individuals who have net worth in excess of \$2 million, or a five-year average of annual net income tax in excess of certain thresholds (*i.e.*, \$139,000 in 2008, adjusted for inflation thereafter) at the time of expatriation.

The Heroes Act will change the current tax regime applicable to expatriates by imposing: (1) an "exit tax" on Covered Expatriates at the time they relinquish their U.S. status; and (2) a transfer tax on certain gifts and bequests that a Covered Expatriate makes to U.S. citizens or residents following expatriation. These new rules will only apply to individuals who become Covered Expatriates following the enactment of the Heroes Act. Significantly, their application to long-term green card holders may differ, depending on the holder's country of residence.

Green card holders approaching the eight year threshold should evaluate their situation carefully as a result of these changes.

Exit Tax

An exit tax, referred to in the Act as a "mark to market" income tax, will apply to Covered Expatriates on the net unrealized gain in their property on the expatriation date. Subject to certain exceptions, general U.S. federal income tax principles will apply to determine the exit tax as though the Covered Expatriate had sold all of his/her property (regardless of its location) on the day before terminating his/her U.S. status. The exit tax on this hypothetical sale, however, only applies to the extent that the gain exceeds \$600,000 (adjusted for inflation in years after 2008). Although a Covered Expatriate may elect under certain circumstances to defer the exit tax on one or more properties, generally until the earlier of the date of disposition or death, such deferred payments incur interest at the rates applicable to underpayments of income tax. Moreover, in calculating gain, long-term residents may claim basis equal to the fair market value of property when they commenced their U.S. residence.

Under current U.S. law, expatriates are not subject to an exit tax, but rather remain subject to an alternative U.S. income tax regime for a period of 10 years following the date their U.S. citizenship or residency terminates.

The Heroes Act also taxes non-grantor trusts on distributions to Covered Expatriates. If the property that the non-grantor trust distributes to a Covered Expatriate has appreciated in value, the non-grantor trust will be taxed on the gain as though it had sold, rather than distributed the property to the Covered Expatriate. In addition, the non-grantor trust must withhold 30% of any portion of such distribution that would have been subject to U.S. federal income tax, had the Covered Expatriate remained a U.S. citizen or resident.

Transfer Tax

The Heroes Act also imposes a new transfer tax on gifts and bequests by a Covered Expatriate to a U.S. citizen or resident. The transfer tax is imposed on the recipient at the highest marginal gift tax or estate tax rate,

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whichever is higher (*i.e.*, 45% in 2008), subject to an annual exclusion amount (*i.e.*, \$12,000 in 2008) and a deduction with respect to gift or estate taxes paid to the taxing authority of another jurisdiction. **Gifts and bequests are subject to the transfer tax, regardless of where the property is located and regardless of whether the exit tax applied to such property.**

The new transfer tax means that *all* assets passing to U.S. heirs and donees of Covered Expatriates will always be taxed. This represents a departure from current law providing certain limits on the length of time and the extent to which the U.S. may tax expatriates. The transfer tax applies to any recipient who is a U.S. citizen or resident; for these purposes, a U.S. resident includes both lawful permanent residents and individuals who have a "substantial presence" in the U.S.

A Covered Expatriate's gift or bequest to a U.S. trust will also attract the transfer tax. In addition, distributions by a foreign trust to a U.S. citizen or resident that are attributable to a gift or bequest from a Covered Expatriate are subject to the transfer tax.

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