Lowenstein Sandler's Trusts & Estates Podcast: Splitting Heirs

Episode 12 -
Home is Where the Heart Is (and where the IRS will try to find you): Thinking of Living Abroad? Even ExPats May Have to Pay U.S. Taxes

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Warren Racusin: We had a client who was the American dream. He came here from Sicily when he was a young man with $25 and the clothes on his back, became a citizen, and over the decades he built a business that became a giant success. Yachts, planes, houses, you name it. If you live in the New York metropolitan area, you probably know the name of his company. But he never got over his love for Italy, even owned a gorgeous home there. He loved the US, but he didn't love paying taxes so much. The one day he decided he wanted to go back and stop being an American, tax purposes, they say. Kept all of his stuff here, of course.

Now, when someone expatriates, as we call it, the way he put it, you have to file some silly forms with the IRS showing what you own. Among other things, he owned a major interest in a hotel in Miami, so he reported on the silly forms that his interest in the hotel was worth about 750,000. One year later, the hotel was actually sold for $175 million.

From the law firm Lowenstein Sandler, this is "Splitting Heirs". I'm Warren. What has our guy gotten himself into, and what can we learn from it about people who have at least one foot in the good old USA and another foot somewhere else? To help us unpack it all, we're going to speak today to my partner Megan Wernke. Megan is resident in our Washington DC office, the perfect place, our national capital, for her practice, which focuses extensively on international and cross-border tax planning. And Megan is going to help us understand some of the issues and the complications.

Let's dive right in. Let's set the stage. Megan, for many folks, the root of the problem here is that for tax purposes, Uncle Sam has some very long arms. What's the story here?

Megan Wernke: You're right, Warren. The United States is really unique in terms of the way that it taxes its US citizens and residents. So unlike most countries in the world, the United States position is that if you are a citizen of the United States, we as a country get to tax all of your worldwide income. Regardless of where it's earned, regardless of where you live, it's just the price you pay, so to speak, for being a US citizen. And so that same rule also applies once you become a green card holder, because then you've got, again, the privilege of entering the United States. And so in return, we're going to tax your worldwide income, no matter where you live.

Warren Racusin: So even if you're not a citizen, if you've got a green card and you're a permanent resident, you're treated just like a citizen for tax purposes.

Megan Wernke: For income tax purposes.

Warren Racusin: Or income tax purposes.

Megan Wernke: Right. So Warren, I think this is a great question, and I want to focus a little bit on income tax first, because what you'll see as we continue this discussion is that actually the rules are annoyingly different from income and estate tax purposes.

So for income tax purposes, there are three different ways that you can get caught in the US net, so to speak. One way is if you are a US citizen. The second way is if you are a permanent resident of the United States, which we commonly call the green card test. And the third way is if you satisfy a statutory test that's called the substantial presence test. And that's kind of a complicated test that's a day-counting test about how long you physically spend in the United States.

So if you fall under any of these categories, you're going to be a US person for income tax purposes and subject to Uncle Sam's long arms, as you called it, that worldwide income taxation.

Warren Racusin: And that's, as you put it, in the view of the IRS, that's the price tag, that's the toll charge, you need to pay for the privilege of being a citizen of the United States of America, right?

Megan Wernke: Yes, that's right.

Warren Racusin: So that's different than most other countries, right?

Megan Wernke: That's right. The United States is extraordinarily unique in this regard. Of course, I don't know every country's law extensively, but my understanding is that there are only two countries in the entire world that tax their citizens on their worldwide income. It's us and Eritrea.

Warren Racusin: A country that we have a great deal in common with. That must be why we approach taxation the same way.

Megan Wernke: Exactly. And in contrast, the vast majority of the major industrialized nations of the world use a residency tax in order to determine whether they're going to have worldwide taxation. And what that means is if you are physically living in the country, then they get to tax your worldwide income, but not simply because you're a citizen that happens to live somewhere else. So that's the most common form of taxation.

Warren Racusin: Now, that's the income tax side of taxation in a cross-border way. In a large nutshell, that's the income tax side. But as you know, we spend a lot of time here on Splitting Heirs talking about estate and gift taxes. And as you hinted at a couple of minutes ago, sounds like the same rules may not apply?

Megan Wernke: So Warren, you're correct that the rules are different for estate tax purposes. It's a separate test, but there is some overlap. So US citizenship is kind of the overarching rule that the United States uses in order to get its arms around your money. So if you're a US citizen, you're going to be subject to worldwide taxation on both the income side and the estate tax side.

Where the rules differ is for non-citizens. So we just talked about the rules for income tax purposes, right? We've got the green card test; we have the substantial presence test. But those rules are actually not applicable in the estate tax context. Instead, we apply a different rule, which is called the domicile rule. And so as a result, it is possible for someone who's not a citizen to be a US person for income tax purposes and not estate tax purposes, or vice versa, to be a US person for estate tax purposes and not income tax purposes, depending on exactly their facts and circumstances and how the different tests apply to them.

Warren Racusin: So how do you know if you're domiciled in the US or someplace else?

Megan Wernke: It would be lovely if there were a simple answer to this question, Warren, but there's not, which I guess is good for us as attorneys, but extraordinarily frustrating for our clients.

The test for domicile is two parts. The first one is that you have a physical presence in the place, set foot in the place. That seems easy enough to resolve, but people with multiple homes or who travel a lot, they're going to set foot in a lot of places. The key part of the test is, okay, you have a physical presence there and you also think of it as your home. You've made a home there with an intent to stay. And I think that, in a sense, is an emotional question for a lot of clients.

And so when taxing authorities are trying to address domicile, what they have to do is look at all of these external indicia of, where do you keep your valuables? Where did you register to vote? Where do you spend Christmas or the holidays with your family? And they use those external factors to try to get at the underlying question, which is, where is your heart? Home is where the heart is. So what do you think of as your permanent home? And the answer to that question is, that would be your domicile.

Warren Racusin: One of our partners has what I've always thought of as a pretty good working definition of domicile. He says, "Imagine you're shipwrecked on a desert island. After years, eventually a rescue boat appears, and the captain steps off the boat, says, 'I'm here to take you home. Where shall I take you?' The answer to that question, that's your domicile."

Megan Wernke: I love that. It sounds exactly true, because again, we're trying to get at, it's the subjective question. Where does the client really intend to stay and make their home? And so the client can think they know the answer to this question, and then it becomes an issue of documentation. How do you show the tax authorities that what you believe in your heart is true in order to convince them that your domicile is where you believe it is?

Warren Racusin: Right. And domicile is important... Taking a little step to the side here for a moment, domicile is important even if you are a US citizen and intend to stay a US citizen. If you live in a high-tax state and you want to move to a low-tax state, you're probably going to have to prove that you changed your domicile for state tax purposes. So if you live in the Empire State or the Garden State and you want to move to the very low-tax Sunshine State, you're going to have to show that Florida has really become your home. So even folks listening to this who aren't planning move to Eritrea, I guess that's a bad place to move, or someplace else, domicile is something that you've got to factor into your equation.

Megan Wernke: That's exactly right. Yes.

Warren Racusin: So our hero decided to expatriate, and you were careful to tell me that when we were preparing for this, I inadvertently sometimes said expropriate rather than expatriate. And I should keep the word straight, although I said some people probably say, as you're about to hear, that expatriation is the same as expropriation. But why don't you take us through that a little bit? When you expatriate from the United States, there's a whole set of protocols that can be expensive that you need to go through. Just kind of take us through that a little bit, Megan.

Megan Wernke: Yeah, so the client that we're discussing here as a US citizen goes through a formal process of expatriation when he renounces his citizenship. And it's a formal forfeiture of your passport. So he would make an appointment at a consular office with the State Department, go in and physically hand over his passport, and give up his right to come back to the United States.

And then in association with that, from a tax perspective, there is a filing. And it's called a Form 8854, and it's something that's included with the final income tax return that you file as a citizen of the United States. And that form both clarifies and notifies the IRS that you have expatriated, you've taken those formal legal steps, and it also provides a listing of your assets and your income from previous years so that the IRS can evaluate whether your expatriation is of tax interest to them.

Warren Racusin: And there is potentially a specific tax that's associated with that process of expatriation. And here's where the expropriation part comes in. Why don't you take us through that and why it was important for our client in this situation?

Megan Wernke: That's right, Warren. So it's popularly called the exit tax, and it's a tax that applies when either a US citizen renounces citizenship, like we just talked about with this client, or in the case of a long-term permanent resident, if they abandoned their green card, so to speak. And there's a different set of very specific rules about what that means. In either of those circumstances, that is considered expatriation for tax purposes.

Warren Racusin: So our hero takes the scary step of expatriating. He files his silly papers and he leaves the country and heads back to his villa in Sicily. He's in the clear now, right, Megan?

Megan Wernke: Unfortunately, he may not be. One of the facts that you told me is that he's going to retain his US residence here. And so when I hear that fact, the first thing I think about is, "Oh, I hope he did not do this in vain." Because remember, when we were talking about the tests for being subject to US income tax, I told you there are a number of different ways to be subject to it. It's not just whether you're a citizen or a long-term permanent resident, but there's that third test, which is the substantial presence test, and it's kind of a weighted day-count test.

And so if our client, despite all these efforts ends up coming back to the US to just visit family and friends and enjoy the sunny weather, he is going to have to count those days. And if he ends up with too many days in the US, he's going to become a US income tax resident again inadvertently. And so he may have done that for no reason.

And there's a similar problem with the estate tax, because remember, the estate tax applies, again, not just to people who are US citizens, but also to people who are US domiciliaries. So of course, our client's position is going to be, "I love Sicily, that is my home, that's where I live." But if the IRS disagrees and it thinks Florida is really the home that he loves and he's spending a lot of time in Florida, the IRS could decide that in fact he's still domiciled in Florida and apply the estate tax to his worldwide assets, despite his expatriation. So the formal step of expatriating is really, in a sense, only the first step. You have to be really careful with your ongoing relationships with the United States in order to ensure that you don't just step right back into the tax snare.

Warren Racusin: So once you get out, you got to stay out, basically.

Megan Wernke: That's correct. You have to be very careful about that. And it's also worth mentioning in the context of covered expatriates that if he has children who remain US persons and US citizens, then when he makes gifts back to his children, there's going to be an inheritance tax applied on that when the money comes back into the United States, into the hands of those US citizens. So being a covered expatriate is a bit of a sticky situation to be in, and you have to continue to be on guard and take appropriate US tax planning measures going forward. Unfortunately, you can't just wash your hands and assume that you're free.

Warren Racusin: Once a covered expatriate, always a covered expatriate, basically, right?

Megan Wernke: That's correct. Oftentimes when we talk about expatriation, we're thinking of it only for US citizens, someone who has given up their passport. But for tax purposes, there are actually two different forms of expatriation. One is the one we just talked about for our client where you do formally renounce your citizenship. But a second form of expatriation is for green card holders. Long-term US residents are going to cease to be residents, and there's a very specific set of rules to test that. And if that's the case, at the point you cease to be a US resident, that is also considered to be expatriation for tax purposes.

So in those two circumstances, there is an exit. And it's gone through a number of different iterations over the years, but the version right now is a mark to market exit tax that applies to a person called a covered expatriate who relinquishes citizenship or long-term permanent residency.

Megan Wernke: So the way that the exit tax works is it's an attempt to calculate the value of what you earned, so to speak, or what you owned as a US citizenship, and make sure that the US gets its cut of that taxes before you head out of the country.

So again, to go back to the privilege of citizenship or the privilege of residency, you lived here in the United States in our wonderful country, and you became a multimillionaire. So you want to leave now, I guess it's okay, but we are going to make sure that we get a cut of the multimillions that you earned while you were here. So the tax is, again, it's called a mark to market exit tax, and what they do is they value your current assets and apply a tax to that when you leave the country. And they only apply that tax if you satisfy a certain test and you're considered to be a covered expatriate.

Warren Racusin: And a covered expatriate is?

Megan Wernke: A covered expatriate is a person that they have determined is of high enough net worth that they're probably expatriating for tax purposes. So there are a couple of different tests there, and they're all tax-related tests. So you can be a covered expatriate if you have a net worth of more than $2 million, or you're a covered expatriate if your average annual income tax liability for the preceding five years exceeded $190,000 per year.

Or you can be a covered expatriate if you are noncompliant with your income tax returns. So if they see any of these three situations, they say, "This looks like a person who is expatriating for income tax purposes. Let's make sure we apply a tax to this person before he leaves the country."

Warren Racusin: The government thinks you're leaving the good old US of A in order to avoid paying taxes. They say "Not so fast. We're going to tax you right now and take our cut," as you said. And that's important for our hero situation, because as I understand it, the tax consists, at least in part, of a tax that's imposed as if you sold your assets on the day you left the United States.

So if you had bought an asset for $100 and on the day you left, it's worth $1,000, the IRS's position and the law is that you've got to pay tax on that $900 of profit as if you had sold that asset on the day you left, right?

Megan Wernke: That's right. It's essentially like a deemed sale transaction.

Warren Racusin: Right. And so that's why someone like our client who says, "My assets are worth $750,000," then they're really worth some major portion of $175 million, could have a problem that the government ever looked at those silly forms that he filed, right?

Megan Wernke: That's right. So normally you only pay this sort of capital gains tax when you actually have a liquidity event. We know how much money you earn, we know how much your asset was valued at, and so it's easy, so to speak, to assess the tax. But in this situation, we're trying to assess the tax against assets that have not been sold, where we don't have a realization event or necessarily as firm valuation.

And so clients are responsible, when they fill out their Form 8854, to try their very best to determine what the fair market value of all their property is. Privately held companies, interest in illiquid funds, interest in businesses that are not easily marketable. And that can be a really complicated process. And that's one reason, I think, that estate tax planners enjoy working in this realm, because it's similar in some senses to what we do for gift and estate taxes, where we need to value assets at their fair market value even though we don't have sales or other clear indicia of the value.

Warren Racusin: So we're going to make it expensive if somebody wants to get out from under the US taxing regime, is the long and short of it.

Megan Wernke: I do believe that that is a fundamental goal of the exit tax. And in fact, in my experience, one of the things that ends up happening is clients will approach us and they'll say, "We are interested in expatriating, let's talk through the rules." And once they realize that they're going to be a covered expatriate and they're going to get hit with this exit tax, the engagement often tends to disappear. People are very rarely interested in paying that exit tax, because the hit is just too large.

Warren Racusin: Which, I guess, means that the rule is working, like it or not, the way it's intended to work, if your experience is representative of other people's experience who counsel clients on this. Sounds like it's working the way it's supposed to work.

Megan Wernke: That's right.

Warren Racusin: Let's briefly take a look at the other side of the coin, because it's interesting also. What if our client had never come to the US in the first place, never lived here, but he owns stuff in the US, businesses, assets, et cetera. Let's say he gets income from his US stuff. What's the income tax or other tax hit, if any, and what might he have to do to pay estate tax, even if he never lived here, to touch both those bases?

Megan Wernke: So the fact that your client is Italian adds some wrinkles to that question. So I think it's worth noting that a number of countries throughout the world have either income tax treaties or estate tax treaties with the United States. And if those treaties are in place, those will often control the answer to this question you just asked. And Italy, I know for example, does have an estate tax treaty with the United States.

But to speak more generally, to set aside the treaty issue and talk about what the background law is... When someone is not a citizen, resident, or domiciliary of the United States, we call them, sometimes the term is a nonresident alien, or a nonresident noncitizen. And these people without personal physical ties to the United States are going to be taxed, for both income and estate tax purposes, where the US feels like it has some hook for jurisdiction.

So for income tax purposes, they ask whether the income that this nonresident noncitizen is receiving is US-sourced. Was it earned from people and sources and assets within the United States? And the US will impose an income tax on those income streams, but obviously not on your worldwide income, because they wouldn't have any basis to do that. That would be unfair and, in fact, unconstitutional.

From an estate tax perspective, then, the question is similar but slightly different. They ask the question whether you have assets that are US situs, so physically located in the United States. And again, that's the US's attempt to assert jurisdiction where it can tax the benefits that you have received from the United States, even if you're not a citizen or resident.

Warren Racusin: Situs being our legal Latin word for where the stuff is, basically.

Megan Wernke: That's right. "Where the stuff is." That would be the non-legal term.

Warren Racusin: And if the stuff is here and you die owning it, Uncle Sam wants to get a piece of that. And remember, for those of you who don't remember some of our earlier podcasts about estate planning, it is a flat 40% tax on US citizens, residents, all of your assets for nonresident aliens for your stuff in the United States. So it is a meaningful tax, as is the income tax.

Megan Wernke: That's true, but fortunately for our clients, that tax actually can often be avoided, because the estate tax is written in a somewhat formulaic way. There are rules about what is US situs, but because of the way those rules are set up, it's often possible to put in place holding structures for your assets to take something that would otherwise be US situs. And we do what we call conversion, so convert that into a non-US situs asset. So with proper planning, you can invest within the United States and not be subject to estate taxes if you use these proper blocker entities.

Warren Racusin: And that's one of the many reasons I am happy that Meghan Wernke is here. She is all about holding structures and makes my life a lot easier and saves our clients a whole lot of money. People have complicated ideas and feelings about home. Thomas Wolfe famously said, "You can't go home again." Carole King sang about being home again and feeling right. Everybody's feelings are different. But one thing's for sure, though, you can have many residences, but you can only have one home. At least, that's what our friends at the IRS think.

So if you have more than one place where you can lie your head down at night, you need to do some careful planning because if you don't, you could lose an awful lot of sleep.

That's all we got for today. Thanks, Megan, for all of those insights. You've clarified a whole lot of information for us and a whole lot of issues for us. Many thanks for that. Thanks to everybody at Lowenstein who makes these podcasts possible. Thanks again to all of you for listening. We'll see you again next time. Until then, as we say in these parts, have a good one.

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