Summary of HEART Law (U.S. Expatriation Tax Provisions)

On June 17, 2008, the President signed H.R. 6081, the Heroes Earnings Assistance and Relief Tax Act of 2008 ("HEART"). HEART adds new provisions to U.S. law that significantly change the tax treatment of persons who give up their U.S. citizenship or long-term permanent resident status.

The law, which adds a new Section 877A to the Internal Revenue Code ("Code"), applies to any "covered expatriate" whose date of expatriation occurs on or after June 17, 2008. A covered expatriate is either (1) a U.S. citizen who relinquishes his or her citizenship, or (2) a long-term resident of the U.S. who ceases to be a lawful permanent resident of the U.S., if the expatriate in either case (A) had an average annual net income tax liability of more than $139,000 (adjusted for inflation after 2008) for the 5 years before the expatriation, or (B) has a net worth of $2,000,000 or more at the time of expatriation. A long-term resident is a person who is a lawful permanent resident of the U.S. (a green card holder) in 8 of the 15 years ending with the expatriation. There are some exceptions, including some relief for dual citizens or persons who relinquish citizenship before age 18-1/2.

For a covered expatriate, the HEART law imposes U.S. federal income tax on all of the expatriate's assets as of the date before the expatriation, as if the assets had been sold on that date. The gain is limited to appreciation that occurred while the expatriate was a U.S. citizen or lawful permanent resident, and $600,000 of gain is exempted from the tax (the exemption is adjusted for inflation after 2008). Subsequent gains or losses on an actual sale will be adjusted for the gains or losses taken into account on the deemed sale under § 877A.

Some special rules include the following:

- The expatriate may elect to defer payment of the tax until the actual disposition of a particular asset (or the expatriate's death, if earlier). If that election is made, the expatriate must furnish a bond or other security for the deferred tax, an interest charge will apply to the deferred tax, and the expatriate must waive any treaty benefits for the tax liability.

- Eligible deferred compensation items (those paid by a U.S. payor for which the expatriate provides notice and waives any treaty reduction) are not subject to immediate tax upon expatriation. Instead, the U.S. payor must withhold 30% from any payment to the expatriate.

- Other deferred compensation items that are not eligible for this treatment will be valued at their present value as of the time of expatriation and taxed as ordinary income at that time.

- Certain tax-deferred accounts such as IRAs or health savings accounts are treated as being fully distributed on the date before the expatriation and are taxed at that time.

- If the expatriate was a beneficiary of a nongrantor trust on the day before the expatriation, any later distribution from that nongrantor trust to the expatriate will be taxed on the amount that would have been taxable if the expatriate were still a U.S. citizen or resident, and will be subject to 30% withholding on that

amount. In addition, if the trust distributes appreciated property to the expatriate, the trust will be taxed as if it had sold the property for its fair market value at the time of distribution.

The HEART law also adds new § 2801 to the Code, dealing with estate and gift taxes. Under § 2801, if a U.S. citizen or resident receives a gift or bequest from a covered expatriate, the recipient will be subject to a special U.S. tax at the highest gift or estate tax rate then in effect (currently 45%) on the value of the property that is received. Exceptions include the following:

- Property that is subject to U.S. estate or gift tax imposed on the covered expatriate that is reported on a timely filed U.S. gift or estate tax return.

- Gifts or bequests within a taxable year whose value is within the U.S. gift tax annual exclusion in effect for that year (currently $12,000).

- Transfers to a spouse or charity that would qualify for the U.S. marital or charitable deductions.

The tax is payable by the U.S. recipient of the gift or bequest, and is reduced by any gift or estate tax paid to a foreign country with respect to that transfer.

The new HEART provisions replace the former expatriation tax regime for a covered expatriate whose expatriation occurs on or after June 17, 2008. The old law continues to apply to persons who expatriated before that date. Under the old law, certain expatriates were subject to an alternative tax regime for 10 years after expatriation. During that 10-year period, certain non-U.S. income continued to be subject to U.S. income tax, tax would be imposed on the expatriate's worldwide income if the expatriate returned to the U.S. for more than 30 days a year during the 10-year period, and gifts of intangible assets were not exempt from U.S. gift tax during the 10-year period. In contrast, the new provisions in § 877A and § 2801 do not have a 10-year limit.

This is a general summary of the new HEART law as it affects the U.S. taxation of expatriates, and does not contain all of the details in the new law. Any affected person should consult a tax advisor as to his or her individual circumstances and the application of the new law.

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