

The Heroes Earnings Assistance and Relief Tax Act of 2008 (the Heart Act) creates an Expatriate “Exit” Tax for Former U.S. Citizens or Long-Term Residents

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Background

On June 17, 2008 The Heroes Earnings Assistance and Relief Tax Act of 2008 (the Heart Act) was signed into law to provide tax benefits and incentives for military personnel and assistance to veterans. Section 301 of this act included a revenue raising provision that created a new “exit tax” on expatriating citizens and long-term residents of the U.S. who expatriate after June 16, 2008.

This “exit tax” applies to a covered expatriate who passes any one of the following tests:

- **Tax Liability Test** - has an average annual net income tax liability for the five preceding taxable years ending before the expatriation date that exceeds a specified amount that is adjusted for inflation (\$145,000 in 2009);
- **Net Worth Test** - has a net worth of \$2,000,000 or more as of the expatriation date; or
- **Certification Test** - fails to certify on Form 8854 that they have complied with all U.S. federal tax obligations (i.e. income, employment, gift, and information return) for the five years preceding the date of their expatriation or termination of residency.

Exceptions

An exception applies for dual citizens and certain minors even if they meet the tax liability or net worth test. However, they are still required to file Form 8854 to provide the information needed to confirm that have complied with the certification test.

Exceptions to the tax liability and net worth test are available to dual citizens (individuals who at birth became a citizen of the U.S. and of another country) who are taxed as a resident of that other country and who have not been resident in the U.S. for more than 10 taxable years during a 15-year taxable period beginning with the year of expatriation. There is also an exception for U.S. citizens who expatriate before reaching age 18 and a half. If they were residents of the U.S. for no more than 10 years during the 15-year period ending with the tax year of expatriation, they will qualify for this exception.

“Market-to-Market Tax”

The “exit tax” itself is based on a “market-to-market tax” regime, under Section 877A of the Internal Revenue Code, which taxes expatriates on the unrealized appreciation of assets that occurred while they were U.S. residents. All assets are valued at fair market and considered sold the day prior to the expatriation date. A gain is recognized if the deemed sale of the expatriate’s assets exceed \$626,000 as adjusted for inflation for 2009. For green card holders, the cost basis used to compute the gain or loss on the deemed sale of assets is stepped up using the date they first became a U.S. resident.

This “market-to-market tax” does not apply to eligible deferred compensation items and interests in non-grantor trusts which are subject to a 30 percent withholding tax at source. For ineligible deferred compensation plans, the present value of the accrued benefit is considered to have been received the day prior to expatriation. For specified tax deferred accounts (Sec 529 Qualified Tuition Plans, Sec 530 Coverdale Education Savings Accounts, Sec 223 Health Savings Accounts, and Sec 220 Archer Medical Savings Accounts), the expatriate is considered to have received their entire interest in the account on the day prior to expatriation.

If you are subject to the “market-to-market tax” you must file Form 1040 or form 1040NR (with Form 1040 attached as a schedule) and attach Form 8854 to your return. An irrevocable election is available to defer payment of the “market-to-market tax” on the deemed sale of property. This deferral will allow the expatriate to pay the tax plus interest in the year

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the asset is sold or subject to disposition. If the asset is not sold during the expatriate's lifetime then the tax is paid on or before the due date of the tax return for the year in which the expatriate dies. In order to qualify for this deferral, the IRS will require adequate security (such as a bond). In addition, you must make an irrevocable waiver of any right under any treaty of the U.S. that would preclude assessment of the "market-to-market" tax. Therefore, if this election is made, you will be filing Form 8854 annually up until the final year the full amount of the deferred tax and interest is paid in full.

Unless you are able to show reasonable cause or no willful neglect, failure to file Form 8854 may result in a \$10,000 penalty for each year of non-compliance.

Further explanation and guidance regarding Section 877A is provided by the IRS with [Notice 2009-85](#).



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