

CANADIAN TAX *Highlights*

New US Exit Tax

On June 17, 2008, the US government enacted the Heroes Earnings Assistance and Relief Tax Act (HEART) of 2008. The act provides relief to certain US military personnel and their families, but it creates a revenue offset of two new tax regimes aimed at certain US citizens and long-term residents contemplating expatriation or termination of their long-term residence: (1) a mark-to-market or exit tax, and (2) a new transfer tax imposed on the US-citizen or US-resident recipient of a gift or bequest of property from certain expatriates.

Mark-to-market (exit) tax. A new mark-to-market rule (Code section 877A) deems the FMV sale on the day before expatriation of property held by certain US citizens who relinquish their US citizenship and certain long-term US residents who terminate residence after June 16, 2008. The net gain in excess of \$600,000 (inflation-adjusted after 2008) is recognized. Subsequent gains or losses realized are adjusted for deemed gains and losses without regard to the \$600,000 exemption.

The exit tax applies to most worldwide property interests held by the individual on the date of expatriation or residence termination. Special rules apply to some deferred compensation items (including stock option and pension rights), interests in non-grantor trusts, and some tax-deferred accounts (such as IRAs and qualified tuition plans). An individual may irrevocably elect to defer the tax's payment, for any or all assets deemed disposed of, by furnishing a bond or other adequate security to the IRS and paying interest for the deferral period at the individual IRS underpayment rate. The deferred tax on a particular asset is due on the due date for the return for the taxable year when the property is disposed of.

The exit tax applies to a US citizen who relinquishes citizenship and a US long-term resident who terminates US residence (covered expatriates) after June 16, 2008 and who (1) has an average annual US net income tax liability for the 5 preceding years of \$139,000 (adjusted for inflation); (2) has net worth of \$2 million or more on the expatriation date; or (3) fails to certify under penalty of perjury that he or she has complied with all US federal tax obligations for the preceding 5 years. A long-term resident (generally, as defined under current law) is an individual who was a lawful permanent resident of the United States in at least 8 of the 15 taxable years before expatriation; long-term US residence terminates when he or she ceases to be a lawful US permanent resident. The new exit tax regime generally preserves the prior rules' exemptions for individuals born dual citizens of the United States and another country or who expatriate before reaching the age of 18½. An individual who expatriated before the new rules' effective date is subject to the prior law, including the 30 days of physical presence test.

New transfer tax provisions. New Code section 2801 imposes a new transfer tax on a US citizen or resident who receives a gift or bequest of property after June 17, 2008 from a covered expatriate under the mark-to-market deemed sale rules. A US citizen or resident who receives property, directly or indirectly, by gift or inheritance from a covered expatriate after the expatriation date must pay tax on the gift or bequest value at the greater of the highest US estate tax rate in effect (45 percent for 2008-9) and the highest rate on the date of receipt. The tax also applies to a US domestic trust recipient; the tax is imposed on a foreign trust when it distributes income or capital to a US citizen or resident.

The transfer tax applies only to the gift or bequest value in excess of the annual US gift tax exclusion (\$12,000 for 2008) and is reduced by any gift or estate tax paid to a foreign country. The new transfer tax does not apply to (1) a property shown as a taxable gift on a timely filed US gift tax return for the covered expatriate; (2) a property included in the covered expatriate's gross estate shown on a timely filed estate tax

return; and (3) a property for which a US estate or gift tax charitable deduction or marital deduction would be allowed if the transferor was a US person.

Because expatriating can now result in immediate and significant US federal income taxes to an individual with substantial assets, an individual who is potentially a covered expatriate should consult his or her US tax adviser before renouncing citizenship or relinquishing a green card. The new transfer tax rules, a significant departure from prior law, must also be considered in any estate planning for covered expatriates with US connections.

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