

## Client Alert

Private Banking: Switzerland

BAKER & MCKENZIE

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## “Mark-to-Market” Exit Tax on Expatriates is Resurrected by Senate to Offset Tax Reduction for U.S. Military—May Become Law Quickly

Just when it looked like the legislation imposing a “mark-to-market” exit tax on expatriates was dead for this year, it came back to life like Frankenstein’s monster. On December 13, 2007, the Senate without notice used it to offset tax relief for members of the U.S. military as part of H.R. 3997, The Defenders of Freedom Tax Relief Act (“DEFTRA”). An almost identical expatriate exit tax was included in H.R. 3056, the Tax Collection Responsibility Act of 2007, which was passed by the House but died of neglect and outright hostility in the Senate and the White House to repealing private tax collection, the core of the legislation. Although the House must still consider and pass DEFTRA, and the President must sign it into law, tax relief for members of the U.S. military is popular, and we think DEFTRA could easily become law within the next few weeks.

To remind everyone of its contents, the new expatriate regime (“Exit Tax Provision”) requires expatriates to recognize gain on their assets, and imposes a new tax on gifts and bequests by expatriates to Americans. This new provision (styled Section 877A) is an addition to (and not a replacement of) the current expatriation tax rules of Section 877. Under the Exit Tax Provision, certain individuals who renounce their U.S. citizenship or U.S. long-term residents who relinquish their U.S. residence status (collectively “covered expatriates”) must recognize gain, or otherwise be taxed, on *all* their assets on the date they expatriate. In addition, gifts or bequests they make to U.S. citizens or residents after expatriation will be subject to tax at onerous estate/gift tax rates.

One bright note is that the Exit Tax Bill, unlike the late summer version, does not impose a tax on gifts or bequests by covered expatriates who expatriated *before* the legislation was enacted.

Nevertheless, the “window” for expatriation under just the current law would appear to be a short one, and individuals and their advisors need to take this into consideration.

**“Covered Expatriate”.** “Covered expatriates” will be subject to both sets of expatriation tax rules. A “covered expatriate” is defined as it is in the existing expatriation tax rules, i.e., anyone who expatriates and who (i) has an average annual net income tax liability for the five preceding years of more than USD

136,000; (ii) has a net worth of over USD 2,000,000; or (iii) failed to certify compliance with U.S. tax obligations for the prior five years.

## Key New Rules

- **“Exit Tax” - Property Subject to Mark-to-Market.** All property of a covered expatriate is deemed to be sold for its fair market value on the day before expatriation (the "MTM" regime). This applies even to U.S. real property interests, apparently to reach a higher revenue estimate by accelerating gain that would be taxed in any event. Covered expatriates must recognize gain on the deemed sale and pay U.S. income tax on gains over USD 600,000 (adjusted for inflation). Some assets are not marked-to-market, but they are otherwise taxed (see below).
- **Gifts and Bequests from Expatriates to U.S. Citizens and Residents Taxed.** U.S. citizens or residents receiving gifts or bequests of over USD 10,000 from a covered expatriate will be taxed at the highest gift or estate tax rate (45% in 2007, and scheduled to increase to 55% in 2011). There is no time limitation to this provision—a person who expatriated could make a gift to a U.S. citizen 40 years after expatriation out of newly acquired assets, and the tax would be imposed on the U.S. citizen. Further, it appears that the donor need not have been a covered expatriate at the time he or she expatriated—*only at the time the gift or bequest was made*. In the statutory language, the expatriate need only satisfy the “covered expatriate” definition, above, *at the date the gift or bequest is made*. So if an individual becomes modestly wealthy (only \$2 million, not adjusted for inflation) after expatriating, any gift he or she tries to make to an American will be taxed to the recipient.
- **Deferred Compensation Items.** Depending on the exact nature of the deferred compensation item, it will be either subject to 30% withholding tax or immediately includible in the covered expatriate’s income and taxable at U.S. income tax rates.
- **Treatment of Specified Tax Deferred Accounts.** A covered expatriate’s entire interest in such accounts (e.g., qualified tuition plan, Archer MSA) will be treated as immediately includible in his or her income and taxable at U.S. income tax rates.
- **Special Rules for Non-Grantor Trusts.** A covered expatriate receiving a direct or indirect distribution from a non-grantor trust will be subject to 30% withholding, regardless of the fact that a lower withholding rate may apply under a treaty. Moreover, non-grantor trusts must recognize gain on distributions of appreciated property to covered expatriates.
- **No Election to Continue to be Taxed as a U.S. Citizen.** Unlike prior versions of the exit tax, the Bill does not allow an expatriate to avoid the new expatriation tax provisions by electing to continue to be treated as a U.S. citizen for tax purposes.
- **Tax Effect of Expatriation.** Expatriation will be effective for tax purposes even if the expatriate does not file Form 8854. Thus, the imposition of the exit tax cannot be delayed (as can application of the present expatriation tax rules) by failing to file Form 8854.

## Simultaneous Application of Existing Expatriation Tax Regime

The existing expatriation income tax rules (Section 877) will also apply to a covered expatriate even though her expatriation occurs on or after the date the Bill is enacted. Thus, for the ten years after expatriation, a covered expatriate would continue to risk becoming a U.S. person for tax purposes under the thirty-day rule of Section 877. In addition, although a Form 8854 is no longer required for an effective tax expatriation, covered expatriates would still be required to file it for ten years. Beyond that, the gain on U.S. assets acquired after expatriation, but sold during the ten-year period, would be taxable in the United States.

Thus the covered expatriate is exposed to a “double whammy” on U.S. assets such as U.S. corporate stock. First, he pays U.S. tax on his gains (in excess of the minimum) on the date he expatriates. Second, when he later actually sells any of those assets that are subject to the current expatriation tax rules within the ten years after expatriation, he’ll be taxed again on appreciation occurring *after* expatriation. And, to add insult to injury, the pre-expatriation appreciation that was excluded under the USD 600,000 minimum from mark-to-market treatment would be taxed under the current expatriation rules.

## Effective Date

The Exit Tax Bill will be effective when the President signs it into law, and will apply to all covered expatriates who expatriate on or after that date.

Although not in new Section 2801 of the Code as such (which imposes the new tax on gifts and bequests from covered expatriates to Americans), the legislation itself (Section 301(f)(2) of DEFTRA) limits the application of this provision to those who expatriate on or after the enactment of the Exit Tax Provision. As noted above, the prior version of this legislation had no such limitation, and thus could have applied to those who expatriated many years ago, so long as, on the date of the gift or bequest, they satisfied the definition of a “covered expatriate.”

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