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Residency for USA Income Tax Purposes

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The USA subjects its citizens and *residents* to USA income tax on their global income. A holder of a valid USA "green card" as well as a citizen is, thus, subjected to USA income tax on their global income even if they are not physically present in the USA.

Recently with the enactment of the *American Jobs Creation Act of 2004* and the 22 April 2005 release of Notice 2005-36, the USA further extended its reach over those subjected to its income tax regime. Individual USA citizens and long-term residents are now subjected to an alternative income tax regime for up to ten years after they renounce their USA citizenship or residency. Long-term residents are those who were lawful permanent residents of the USA in at least eight taxable years out of fifteen.

The policy purpose behind these changes is to make it more difficult to avoid USA taxes by altering one's citizenship or residency.

Under prior law, there was a rebutable presumption of USA tax avoidance when an individual renounced their USA citizenship or residency.

This new law replaces this presumption with an objective standard. An individual renouncing citizenship or residency in the USA will be subjected to a new alternative USA income tax regime for 10 years if the individual meets **any one** of the following:

- Fails to certify compliance with all USA tax (income and otherwise) for the five prior years.

- Had an average USA income tax liability greater than US$124,000 (adjusted for inflation) for the five prior years.

- Had US$2,000,000 or more in net worth upon renouncing their USA citizenship or residency. (This may be more easily met than one would think considering the values of USA homes, Individual Retirement Accounts, 401(k) Plans and so on.)

Regardless of the actual facts, USA Citizens and long-term residents will continue to be taxed on their global income until they give affirmative notice to the USA State Department or the Department of Homeland Security that they have relinquished their citizenship or residency. This is done through the filing of Form 8854.

Form 8854 requires the disclosure of:

- When and where the individual emigrated.

- The individual's income tax liability for the five prior years.

- The individual's net worth.

The alternative income tax regime to which the expatriate is subjected is a combination of that imposed on USA citizens and nonresident aliens. A nonresident alien is subjected to a 30% tax on passive income such as interest and dividends unless a lower rate is provided by treaty. A nonresident alien is then taxed at regular USA tax rates on USA sourced income. For this alternative tax regime, the definition of USA sourced income is broader including gains on the sales of USA stock and debt.

While subject to this USA alternative income tax regime, an individual's physical presence in the USA can cause a reversion of their USA tax status to encompass their entire global income under the typical tax regime applied to USA citizens.

- Presence in the USA during the tax year for more than 30 days but less than 60 days will result in the application of full USA taxation unless one is employed by a business not owned directly or indirectly by the individual in question or certain family members. The expatriate must also pay income tax in the country of their birth.

- Presence in the USA for more than 60 days during the tax year subjects the expatriate to full income taxation by the USA on global income.

Failure to comply including the annual filing of Form 8854 due each 15 April for most, results in a US$10,000 penalty. This is in addition to any tax, penalties and interest otherwise due.

Where taxes or penalties are not promptly paid, other consequences could also follow such as:

- The loss of property over which the USA could assert jurisdiction.

- The inability to travel in or through the USA and its territories.

Possible solutions:

- Long-term planning including the timing of income and deductions before and after emigration or immigration.

- Re-examining the rationale for emigration or immigration. Retention or acquisition of full USA taxation may be advantageous. For example, seeking residency status in the country to which one is emigrating rather than full citizenship. Often, taxable income declines or can be managed to do so in the early years of residency in the new country. This period may then facilitate meeting the tests for prior USA income taxes.

- Gifting property or portions of property to family members may decrease net worth. Portions of property can be measured in time as well as physical portions. Care needs to be exercised. Once property is given to others, it is not retrievable. At the moment, the USA and some states also have a tax on the transfer of assets including by gift.

- Use of annuities including charitable annuities prior to emigration might assist in meeting both the income tax and net worth tests.

- Management of the USA foreign tax credit regime may result in significant reductions in USA income taxes while planning changes in USA citizenship or residency.

- Those with USA “green cards” might consider relinquishing them before they become ensnared in “long-term” USA residency.

- Those contemplating obtaining USA residency might wish to re-think their goals.

As with all tax matters, each person's and family's circumstance is unique. Thus, consultation with counsel and a tax advisor before significant decisions are made is a must.