New Law Makes Escape Tougher For Tax Exiles

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It's been called "the ultimate estate plan": moving to a desert island or other far-off locale to escape the clutches of the Internal Revenue Service.

Indeed, hundreds of Americans do formally renounce their U.S. citizenship every year, many in order to protect their wealth from income, estate and gift taxes. But last week, Congress may have made life less rewarding for tax exiles.

Some exiles were born and raised in the U.S., such as John Dorrance III -- grandson of the inventor and entrepreneur who helped found Campbell Soup Co. -- who renounced his citizenship in 1994 and emigrated to Ireland, which has significantly lower tax rates. Others have long lived outside the U.S. and are seeking to avoid the unique consequences of its tax system, which taxes its citizens no matter where in the world they live and earn.

The IRS's Last Laugh

A new law passed by Congress seeks to collect more from U.S. citizens and permanent residents who leave the country to avoid taxes:

- **Assets of those leaving** the U.S. for good will now be taxed as if those assets were being sold.
- **U.S. heirs** of ex-citizens will pay a new tax on gifts and inheritances.
- **The tax rules** apply only to those with a net worth of more than $2 million.
- **Some 470 Americans** formally gave up their U.S. citizenship in 2007.

Source: WSJ research

In 2007, 470 Americans renounced their citizenship to move abroad, according to a Wall Street Journal review of Federal Register notices. The list of those who relinquished U.S. citizenship in the past 12 months includes a London-based office-supplies magnate and the daughter of an Iraqi private-equity billionaire.

Now, after years of threatening to do so, Congress has passed a law that will tax the assets of those who leave for good on their way out the door, as if they were selling those assets. But tax experts say the more significant change may be a provision that taxes U.S. heirs on amounts given or left to them by ex-U.S. citizens. Taxing the recipient instead of the donor will make it harder to get around the tax rules.

"The new rules say, if you leave any of your property to a U.S. person, it will be taxed at the rates for U.S. gift tax," which are currently 45%, says Henry Alden, a certified public accountant at Everest International Group, a Baltimore-based financial-planning firm. The new taxes are included in legislation providing tax benefits for soldiers and military veterans and will apply only to those who renounce their citizenship after President Bush signs the bill into law, as he is widely expected to do.

Some of those permanently leaving the U.S. for tax reasons are private-equity deal makers, hedge-fund managers or entrepreneurs who have made fortunes here, whether born in the U.S. or elsewhere. Others are foreign-born, often academics, who have gained citizenship but are repatriating to their native countries after an extended stay.

One former citizen is Serra Nemir Kirdar, an advocate for Arab women in business and daughter of the Iraqi-born billionaire Nemir Kirdar, founder of private-equity powerhouse Investcorp. While born in the U.S., Serra Kirdar was educated at Oxford and now resides in the United Arab Emirates. "I very much believe that it is the responsibility of people who hold citizenship where they reside to pay their taxes," Ms. Kirdar said in a telephone interview. "In the event that someone doesn't live there or make use of the protections that come from citizenship, they should not be liable for paying taxes to a country they just hold a passport from."

Another former U.S. citizen is George Karibian, founder and chairman of U.K.-based online office supplier Euroffice. Through a spokeswoman, Mr. Karibian declined to comment for this article. His biography posted on a trade-group Web site indicates that since graduating from the University of Pennsylvania's Wharton School in 1993, he has lived and done business in various European locales.

Lawmakers have been struggling for years to change a tax system for expatriates that was cumbersome yet easy to circumvent. "The old law was very easy to manage, with the right advice," says Evelyn Capassakis, an estate planner at PricewaterhouseCoopers in New York.

Under the old system, tax exiles were required to file annual U.S. returns for 10 years after they renounced their citizenship. For that time period, income tax was owed on all U.S.-source income. Estate and gift taxes also applied to U.S. assets transferred during that period.

The system encouraged people to hold onto their U.S. assets until after the 10-year period expired and then unload them. And while estate taxes still applied to intangible assets such as stock in U.S. companies, gifts of U.S.-based stock were not taxed after the 10-year period. "Patience was rewarded under the old regime," says Mr. Alden.

Under the new law, the 10-year transition rule is abolished. U.S. citizens and long-term residents who are terminating their status will be taxed once on their unrealized gains, at current market rates. Stock portfolios, real estate, art and most other types of assets will be captured by this new "mark to market" tax. Some experts say the new law could deter some citizens or residents from leaving the U.S., since the benefits of doing so will be reduced. Yet the simplicity of the new one-time tax may appeal to others.

One aspect of the new law that has practitioners concerned is that it applies not only to U.S. citizens but long-term residents. That means it will capture foreign executives who have been permanent residents of the U.S. for more than eight years. "There are a bunch of green-card holders who may fall prey," says Mr. Alden. They may now owe taxes to both their native country and the U.S., he says.

As in the old system, the new rules are triggered only for individuals with a net worth of $2 million or more, or who owed more than $124,000 in income taxes on average over the past five years, indexed for inflation. Even if one of those conditions is met, the first $600,000 in gains are not subject to the tax.

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