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U.S.-Israeli Tax and Estate Planning for Dual Citizens

Reconciling U.S. and Israeli Law on Trust Taxation, Inheritance Laws, and Wealth Transfers

TUESDAY, AUGUST 23, 2022

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today's faculty features:

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Estate Planning & Probate for the Global Family Involving the U.S. & Israel

Osher Felicia M. Haleli, Esq.

Not Only Domestic Planning

- Local estate planning attorneys must seek help.
  - Learning curve – cross border issues
- Pourover Will + Living Trust structure has pitfalls in Israel
- Transfer Certificate requirement

Team Work

- US CPA
- Israeli CPA
- US Estate Planning Attorney
- Israeli Attorney
- Financial Advisor if relevant

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Client Education

- ✓ U.S. citizens residing in Israel unaware U.S. tax applies.
- ✓ Unaware of Transfer Certificate requirement
  - ✓ IRC Sec. 6325
  - ✓ 26 CFR 20.6325-1
- ✓ U.S. Federal estate & gift taxation in "mixed marriages"

- Pourover Will + Living Trust structure has pitfalls in Israel

- IRS Minimum Required Distributions at age 72

Incompetency

- One Power of Attorney for each country.
  - No cross-border PoAs.
  - Avoid Guardianship

Community Property

- Israel is a community property jurisdiction.
  - Consider impact on client's estate plan & assess risk if there is a separation or divorce.
  - Review pre & post-nuptial agreements for tax issues
  - Note US Federal Estate tax issues and prepare

Minor Children

- ✓ Israeli Wills holding estate for U.S. minors – foreign non-grantor trust?
- ✓ Minors who are named as heirs to U.S. assets
  - ✓ Guardianship

Gift Tax Issues

- Buying child a home
- Child residing rent-free
- Unaware of gift tax and annual exclusion

Capital Gains Tax Issues

- ✓ Step up in basis U.S. vs. Israel
- ✓ Anticipated US tax reform – check each family's situation for relevancy
- ✓ Synchronize year in which both US & Israeli CGT apply

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Miscellaneous Issues

- Should US citizens apply for citizenship for their children?
- Was a non-citizen, non-resident ever a green card holder? Exit tax issues
  - Start asking your clients!
- Renunciation of citizenship a possibility?

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Israeli Income Tax Treatment of Foreign Trusts

Matthew A. Levitsky, Esq.
Gidon Broide, CPA

Income Tax Treatment of Foreign Trusts

- **Israeli Income Tax Treatment of Foreign Trusts**
  - Prior law
    - Until 2014, Israel generally exempted from its income tax any trust that had been created by a foreign (such as U.S.) person, even if there were Israeli resident beneficiaries.
    - Similarly, Israel did not attempt to tax the Israeli resident beneficiaries on any trust distributions.
    - Israeli resident beneficiaries did not have to report a cash distribution received from a foreign-settled trust. Although not taxable, the advice was to report the income as tax exempt.

Income Tax Treatment of Foreign Trusts (Cont'd)

- **2014 Law imposing income tax on trusts with all foreign settlors and with Israeli beneficiaries.**
  - Under the law that became effective 8/1/2013, many of these previously tax-exempt trusts and/or their Israeli resident beneficiaries have become subject to significant Israeli income tax liabilities and reporting obligations beginning with the tax year starting 1/1/2014.
  - Trustees have a number of reporting obligations, as well as tax filing deadlines. There is an apparent lack of knowledge in the U.S. among professionals – trustees, attorneys, accountants – about these compliance requirements.
  - Tax is imposed only on the portion of trust income attributable to Israeli residents.

Income Tax Treatment of Foreign Trusts (Cont'd)

- As practical matter, in most cases, U.S. trusts that report and pay income taxes in the U.S. will likely have little or no additional Israeli tax liability, but still need to register and file tax returns.
- The law was intended to tax all trusts with an Israeli beneficiary. This presentation will assume the trust was created in the U.S.

Income Tax Treatment of Foreign Trusts (Cont'd)

- **Relative vs. Non-Relative Trusts**
  - Under the 2014 law, an Israeli Beneficiary Trust (IBT) is a trust under which all settlors (sometimes called grantors) are foreign (non-Israeli) residents, and there is at least one Israeli resident beneficiary.
  - An Israeli Beneficiary Trust (IBT) can be either a Relatives Trust or a Non-Relatives Trust. Being a Relatives Trust permits two choices of timing and rate of taxation.
  - See "decision tree" on slide at end of outline.

Income Tax Treatment of Foreign Trusts (Cont'd)

- To determine if you have an Israeli Beneficiary Trust, you need to know <u>if there is an Israeli beneficiary currently</u>.
- A beneficiary who is not entitled to distributions until after the death of a prior beneficiary (or the death of the grantor, perhaps in a typical insurance trust) is not considered a beneficiary until after the death occurs.
  - For example, in a very common situation in U.S. estate planning, U.S. husband establishes a trust under his will for his U.S. wife for her lifetime, after which his children (some of whom reside in Israel) are the remainder beneficiaries.

Income Tax Treatment of Foreign Trusts (Cont'd)

- The children are not considered "beneficiaries" while their mother is alive.
- Therefore, the trust is not required to register or report until 60 days after the mother's death.
- No Israeli tax is imposed on the trust income during the mother's lifetime.
- This allows some planning options while the mother is alive, so attention should be paid to the trust even before the reporting and taxation is applicable.

Income Tax Treatment of Foreign Trusts (Cont'd)

- **A Relatives Trust** must have two characteristics:
  1. Settlor is still alive [note for this purpose, if the Settlor's spouse survives the Settlor, and was married to the Settlor at the time the Settlor made contributions to the trust, then the trust may maintain its Relative Trust status for the remaining lifetime of the spouse].
     1. Once there is no more living foreign Settlor [or spouse], the trust becomes a regular IBT.
  2. Settlor is closely related to Israeli resident beneficiary.

Income Tax Treatment of Foreign Trusts (Cont'd)

- **A Non-Relatives Trust** is subject to Israeli income tax (at regular rates of 25% for passive investment income and marginal rates from 15%-52% on other income, such as rental or business) on world-wide income, on the portion allocable to the Israeli resident beneficiary.

Income Tax Treatment of Foreign Trusts (Cont'd)

- A Relatives Trust may elect to be taxed in one of 2 ways:
  - **Annual Tax Regime**: An annual tax, at the rate of 25%, is imposed on the trust level on the portion of the income allocated to Israeli resident beneficiaries.
    - Subsequent trust distributions are not taxed to the beneficiary.
    - In most cases, the annual tax regime makes sense, particularly for a trust expected to make any distributions within the next 15-20 years.
    - This is similar to how trusts are taxed in the U.S.

Income Tax Treatment of Foreign Trusts (Cont'd)

- **Deferred (or Distribution) Tax Regime**: No annual tax is imposed on the trusts. However, the Israeli resident beneficiary is taxed, at the rate of 30%, upon distribution of trust income.
  - The law presumes that distributions come first from income (except original capital contribution to trust).
  - The law does not specify how to determine the allocation between Israeli and non-Israeli beneficiaries.

Income Tax Treatment of Foreign Trusts (Cont'd)

- Choice of Annual vs. Deferred Tax Regime
  - Economically, it often is better to use the annual tax regime, fling similarly to the U.S. filing and taking the credits for U.S. tax as it is paid.
  - The crossover point when it is economically better to choose the deferred taxation at a higher rate can be as much as 17-20 years.
  - Although annual tax returns are not required for the deferred tax regime, the Israeli accountant will need to prepare an ongoing internal schedule of all income and taxes paid, to claim the future credit when distributions are ultimately made, so deferred regime may not save professional fees.

Income Tax Treatment of Foreign Trusts (Cont'd)

- Usually the ITA will accept a reasonable allocation as long as the allocation is in fact followed in making distributions (for example, if the trust has five beneficiaries, one of whom is Israeli, income can be deemed 20% taxable; but if more distributions are made to the non-Israeli beneficiaries, maybe a smaller percentage will be taxable by Israel).
- The taxable portion for the Israeli beneficiary must be listed on the registration of the trust, and changes must be reported.

Income Tax Treatment of Foreign Trusts (Cont'd)

- **2016 Israeli Tax Authority Circular Guidance**
  - In August 2016, the Israel Tax Authority ("ITA") issued a circular with some guidance on the application of this law.
  - The guidance confirmed that <u>any U.S. tax paid on trust income will be applied as a tax credit against Israeli tax, regardless of whether the tax was paid by the Settlor, the trust, or the beneficiary</u>.
    - However, to prove the amount of U.S. tax paid by a grantor or beneficiary, you may need to provide that taxpayer's personal income tax return, which may not be acceptable to the taxpayer.

Income Tax Treatment of Foreign Trusts (Cont'd)

- This is especially important for U.S. grantor trusts, where the grantor pays the U.S. income tax on trust income.
- Matching U.S. tax payments to trust income for purposes of the credit will be much easier under the Annual Regime than under the Deferred Regime, because both countries will be imposing their tax on a current basis in the same year.
- For most trusts paying U.S. tax, there will be little, if any, Israeli tax to be paid on the trust income; however, the reporting requirements still apply.

Income Tax Treatment of Foreign Trusts (Cont'd)

- Since 2017, an amendment to the 2014 law requires Israeli beneficiaries starting from age 25 to file annual income tax returns if the assets of the trust are valued at NIS 500,000 or more (assuming they are aware that they are beneficiaries), even in years that no distributions were made.
- It is unclear what happens if the trust assets decrease in value below NIS 500,000, due to market fluctuations or exchange rates, after the beneficiary has previously reported. In practice, since file already exists, reporting recommended.
- Filing Requirements

Income Tax Treatment of Foreign Trusts (Cont'd)

- Notification of Trust Existence:
  - Existing Trusts as of 1/1/2014: was required by end of January 2014.
  - New Trusts: within 60 days of creation.
- Israeli Resident Beneficiary:
  - After beneficiary reaches age 25.
  - Any Israeli resident beneficiary who receives a distribution.
- Choice of Annual or Deferred Tax Regime.
- Income Tax Returns.
- Forms.

Income Tax Treatment of Foreign Trusts (Cont'd)

- Negotiated Arrangements with ITA
  - Past [pre-2014] tax liabilities.
  - May be option for step-up on asset basis.
  - May initiate discussions on an anonymous basis.
- Planning Recommendations
  - Separate trusts for Israeli resident and non-resident beneficiaries will avoid issue of how much of trust income should be apportioned to Israeli beneficiaries.
    - In practice sub-accounts in investment or bank accounts can achieve the same result.
  - If a beneficiary has direct or indirect control (such as investment decisions, lifetime power of appointment), the trust will be considered an Israeli trust, subject to regular taxation.

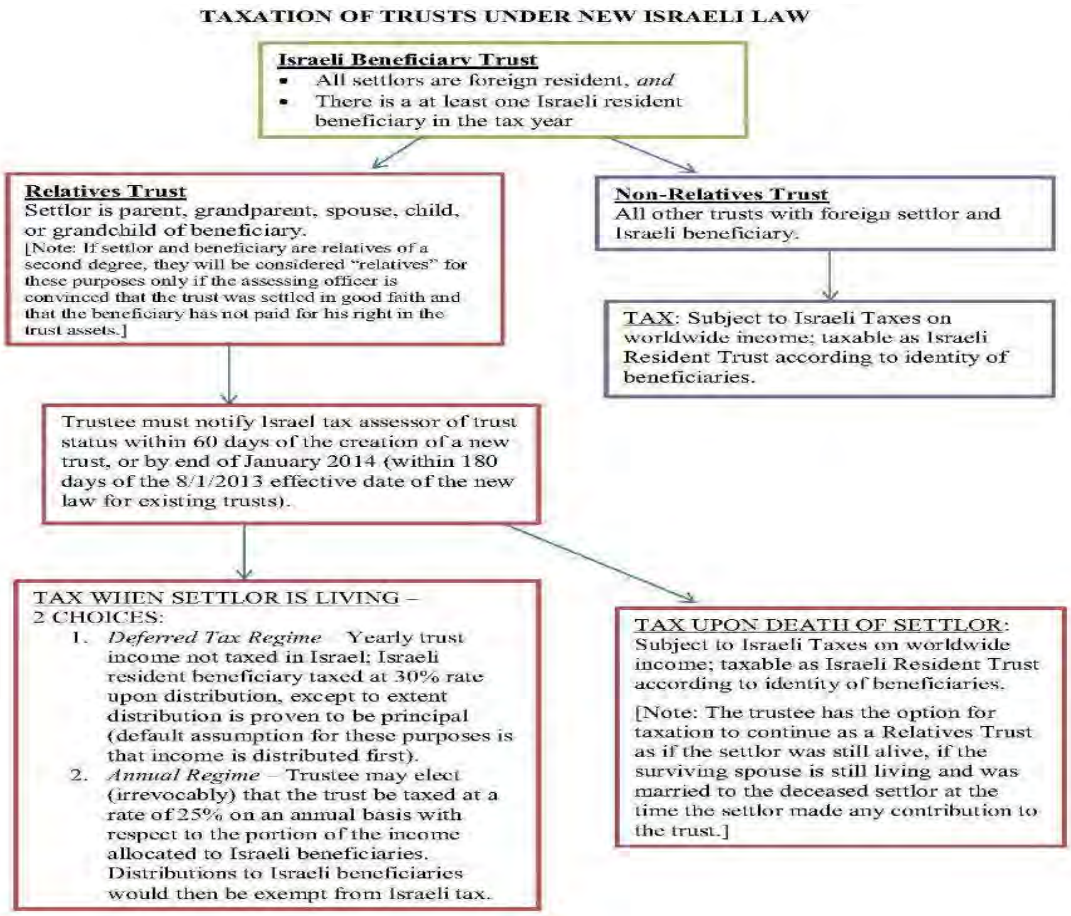
Income Tax Treatment of Foreign Trusts (Cont'd)

- Open Issues.
- Enforcement of law against foreign trustees
  - Will any (civil or criminal) penalties be asserted against a trustee who does not comply with filing/payment requirements?
  - How will this be enforced against foreign trustees? Severe penalties/tax rates for Israeli beneficiaries.
    - Initial responsibility is on the trustee, but the ITA can pursue the Israeli beneficiary.

10-Year Tax Holiday

- 10-year tax holiday is available to new Israeli residents ("olim chadashim") and to returning residents who lived at least 10 years outside of Israel.
- Any income from assets held prior to immigrating to Israel is tax exempt and not reportable.
- The exemption is relevant to IBT's, which are exempt from paying tax and reporting trust income during the 10-year exemption period
- In many cases registration of the trust during the 10-year period is recommended, even though the trust is exempt from taxes and reporting.
- Sometimes there are planning opportunities during the 10-year period
- Any beneficiary over 25 is also not required to report his status during the 10-year holiday.

Decision Tree



General Points

An arrangement, whereby a trustee holds assets for a beneficiary, may be defined as a trust, even where not formally established under Trust Law, locally or abroad.

Under certain conditions, the settlor/grantor may report to the Tax Authority (and thus be the taxable entity) and not the trustees.

Where the beneficiaries of a foreign settled charitable trust are public institutions – as defined – then they will retain their foreign status.

There is not always full clarity nor certainty in the approach of the ITA to taxation and reporting of trusts in Israel. This should be born in mind.

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Registration of Trusts in Israel – Forms and Required Information

Form	Purpose	Relevant for *, **	Documentation
152	Registration form	All IBT's	Trust agreement, death certificate of Grantor (if applicable), copy of Trustee's passport, Trust company certificate of incorporation and registration number, copy of Grantor's passport, copy of Beneficiaries' Israeli ID
147	Registration form	All IBT's	
151	Annual Trust information	All IBT's	List of Trust assets at book value, list of distributions to beneficiaries
141	Notice of Irrevocable trust	Irrevocable trusts	
143	Notice: Foreign Beneficiary Trust	FBT's – Israeli grantor	
144	Election of Grantor/Beneficiary as tax representative	Some IBT's	
148	Notice: Choice of allocation of taxable income to Grantor or to Beneficiary	Some IBT's	Trustee must still register trust, but in some cases, can choose to have Grantor or Beneficiary pay tax
153	Notice of Underlying Holding Co.	IBT's with Underlying Co.	For each company: certificate of incorporation
154	Relatives trust: Election of tax route	Relatives Trust	

***IBT – Israeli Beneficiary Trust** ****FBT – Foreign Beneficiary Trust**

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Reporting Trust Taxes in Israel

Form	Purpose	Signed by	Information
1327	Annual Trust tax return	Israeli CPA US Trustees	
1219	Asset Declaration	Israeli CPA US Trustees	Recently, the ITA sent requests for asset declarations to many trusts that have registered since 1.2014
1324	Schedule D – Foreign Income and foreign tax credits	Israeli CPA	• For Trust – **1041** or equivalent schedule. • **K1**'s if applicable. • **1040**'s - If any trust income is taxable on 1040's of the Grantor and/or Beneficiaries, to claim a tax credit for taxes paid in the US.
151	Annual Trust information	US Trustees	• Annual list of additions to trust assets. • Annual list of distributions to beneficiaries (**all principal and income** distributions, not just income distributions).

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U.S. – ISRAEL TAX TREATY

Mechanism and Implementation

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US – Citizenship

- U.S. taxes worldwide income based on citizenship. Residency has very little significance for federal tax purposes.

Israel - Residency

- Israeli taxation (and almost all other countries) is based on residency based on number of days and "center of life".
- The Tax Treaty is extremely important here in order to avoid double taxation for those who are subject to taxes in both countries – dual reporters.

Treaty Mechanism – Dual Reporters

- U.S. Citizens (and some Green Card holders) living in Israel are generally obligated to file both Israeli and U.S. tax returns.
- They are subject to taxes on their worldwide income.
- Israeli residents may claim a foreign tax credit on their U.S. return for taxes paid in Israel (certain limitations apply)
- Israeli residents may claim a foreign tax credit on their Israeli return for taxes paid in the U.S. (certain limitations apply)
- The end result should be a tax liability equal to the highest tax rate (Israel/U.S.) for each type of income, and generally no double taxation of income.

Basic Treaty Mechanisms

- Who (Israel/ U.S.) taxes the income first – right to "first bite"
- Utilizing deductions
- Utilizing foreign tax credits
- Planning to avoid partial double taxation
- Tax rates applicable for each country

The Numbers: Comparing Tax Rates (2021)

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Income	United States (Top rates per category)	Israel	Israel + Wealth Tax (Income above NIS649,560)
Ordinary Income	**37%**	**47%** (top marginal rate)	**50%**
Dividends	**40.8%** Regular, **23.8%** Qualified	**25%** [30%*]	**28%** [33%*]
Interest	**40.8%,** 0% Municipal Bonds	**25%** [30%*], 15% ** [33%*]	**28%** [33%*], 18%** [21%*]
Capital Gains	ST **40.8%**, LT **23.8%**	**25%** [30%*]	**28%** [33%*]
Rent US/Israel	**40.8%**	**30%-47% -** full deductions & foreign tax credit allowed.*** **15%** of gross income: US property, only depreciation is deductible, no tax credit allowed. **10%** of gross income: Israeli residential property, no deductions allowed. **0%** : Israeli residential property, up to NIS5,090 per month (other limitations apply).	**50%** **18%** **13%** **0%**
		**** 0%-47% for taxpayers aged 60 or older*	** Controlling Shareholder* *** Unlinked instruments*

Israeli Taxes on U.S. Income

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Income Type	Israeli Taxes	Comments
US Pension	Reduced rate per Sec. 9(c)	Taxed at the same rate it would have been taxed in the US
Social Security Benefits	Exempt	
Income from Trusts	Trust usually files a separate tax return, in some cases income may be reportable on personal tax return	Requires registration of trust with Israeli beneficiaries and annual tax filing - Its crucial to consult with an Israeli tax expert

Israeli Taxes on U.S. Income

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Entity	Israeli Taxes	Comments
Partnership	Pass-through to taxpayer	
Corporation	1. Corporate taxes 23% 2. Dividends 25%/30%	
LLC	Taxpayer must elect to be taxed as pass-through, otherwise, will be taxed as corporation	LLC's are seen as separate legal entities. The ITA will not allow using losses from one to offset profits from another

Who Gets the Right to First Bite?

(Article 26(2) of Treaty)

The Right to First Bite (Article 26(2) of Treaty)

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Real Estate Rental Income	Location of the Property
Dividend, Interests, Royalties	Where Earned
Capital Gains	Country of Residence
Capital Gains from Real Estate	Location of the Property
Business Income	Country of residence unless work performed in the other country in which the taxpayer has a permanent establishment or even where no permanent establishment
Salary/Employment Income	Where earned, unless the taxpayer spends 183 days or more in the other country during the tax year (Section 16)

Deductions:

- Israel Tax Authority will generally allow actual expenses and unlike the IRS will not cap some of them.
- The U.S. standard deduction can't be used as a deduction for Israeli tax purposes.
- Charitable contributions are used as tax credit (35% of contributions subject to ceiling) and not as deductions.
- When using the standard deduction in the U.S., ask your professional to provide a Schedule A of itemized deductions (may be used on your Israeli return).
- Some U.S. unallowable deductions are allowed in Israel – interest expenses, investment management fees, legal, accounting and tax preparation fees.

Foreign Tax Credits

Israel will allow - in most cases - a $ to $ tax credit for US taxes paid on income taxed by the US in accordance with the Treaty. Tax credit will be limited to the tax rate applicable in Israel.

Foreign tax credits, not utilized during the current year can be carried forward for five years.

For foreign tax credit purposes, US taxes should be allocated to the various types of income – specific allocation or average are generally accepted.

U.S. state income taxes may be used as a foreign tax credit.

The ITA will not permit a tax credit for the additional Medicare surcharge.

There Is NO Social Security Treaty

Israel has no Social Security treaty with the U.S.

Social Security benefits are exempt from income tax based on the income tax treaty

Payments to Social Security are usually not deductible

Other U.S. income such as real-estate income may be subject to both Social Security and Israeli National Insurance (unless taxed at 15% route)

Self Employment Tax (15%) is not deductible and may not be applied as a foreign tax credit – this requires tax planning to avoid double taxation

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10 Year "Tax Holiday" Overview

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10 year "tax holiday" is available to new immigrants/residents and to returning residents who lived at least 10 years outside of Israel.

Any income from assets held outside of Israel is tax exempt and not reportable .

Remember: There are planning opportunities during the 10-year period:

- Freedom to create, change, cancel
- Serious planning before the end of the 10-year period.

Plan in Advance:

Israeli Tax Considerations

- **US Business/Companies Income – Possible 10Y tax exemption**
  - Should not require actual work in Israel other than general/management
  - Actual/significant business activity in the U.S., with full-scale U.S. infrastructure.
  - Consider separate agreements/entities when working in both U.S. & Israel.
- U.S. **payroll – Full/partial exemption during 10Y "tax holiday".**
  - When actual work is performed outside of Israel.
  - Consider separate agreements/entities when working in both U.S. & Israel.

Israeli Tax Filing: Other Considerations

- U.S. Charitable Contributions – subject to certain limitations, can be claimed – will generate a 35% tax credit (subject to ceiling). Does not apply to Trusts and Foundations.
- Don't overlook Social Security/National Insurance.
- ESOP – Employee stock option plans require coordination between U.S. and Israeli tax advisors.
- Israeli Exit Tax implications should be considered.
- **Make sure your Israeli and U.S. CPA/tax advisors are aware of the specific issues related to Israel-US taxes.**

Summary - Costly Mistakes

Not applying the first bite rules properly

Timing: Ignoring different timing of tax events such as - 1031 exchange when there's an Israeli reporting requirement. This will cause a tax "accident" and result in double taxation.

Not planning for the 10-year "tax holiday", and also its termination

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Failing to register and report a trust with Israeli beneficiaries

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U.S. – Israeli Tax and Estate Planning for Dual Citizens:
U.S. Disclosure Requirements
Structuring and Planning Prior to Emigration to Israel

August 23, 2022

K. Eli Akhavan, Partner, Steptoe & Johnson LLP

U.S. Disclosure Requirements

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Income tax reporting

- All US persons must file (US citizens and greencard holders) must file annual tax returns even if all the income is earned outside the United States.
- Most US-Israeli citizens living in Israel won't owe US taxes because of taxes paid to Israel.
- Foreign Earned Income Exclusion under Section 911 of the Code allows a US taxpayer who is a resident of a another country to exclude from gross income, income earned from services performed in another country.

US Reporting and Disclosure Requirements

- US citizens who are also residents/citizens of Israel must report their foreign financial accounts and assets if they meet the requisite thresholds.
- Owning or having signature authority over a foreign financial account that has more than $10,000 will require filing FinCen Form 114.
- IRS Form 8938 – Statement of Specified Foreign Financial Assets should be filed by US citizens living in Israel as follows:
    - Single taxpayers who own foreign financial assets that are worth $200,000 on the last day of the year, or $300,000 at any time during the year.
    - Married filing jointly taxpayers who have foreign assets of $400,000 on the last day of the year, or $600,000 at anytime during the year.
- IRS Form 3520, IRS Form 3520-a
- Worldwide income and estate/gift taxation

Information Exchange Agreement

- Israel and the United States have entered into an Intergovernmental Agreement ("IGA") under which Israel's financial institutions submit FATCA (Foreign Account Tax Compliance Act) reporting information to the Israel Tax Authority, which will automatically exchange the information with the U.S. Treasury).

- Essentially, banks in the United States and banks in Israel must report each other's residents' bank accounts.

Planning Strategies Prior to Emigration to Israel

- Trust settled prior to Grantor moving to Israel will not be subject to tax in Israel if:
  - (1) Trust is irrevocable (not a revocable trust, i.e., 10 requirements are met, and trustee and grantor declared in an affidavit to the ITA as such)
  - (2) All the beneficiaries during the tax year are foreign residents and can be identified
    - Beneficiary who emigrates to Israel turns the Trust into an Israeli beneficiary trust, subjecting it to reporting and taxes in Israel
- Designated Trust
  - This works only for irrevocable trusts (high threshold to meet in Israel to become an irrevocable trust)
  - You would divide the trust fund by designating a precise portion to each beneficiary
- Trust Division
  - Divide trust so that the Israeli beneficiary is the only beneficiary in the trust (decanting)
- Trust Exit – must make sense from US tax and asset protection perspective

U.S. Exit Tax

- Covered Expatriate will be exposed to the Exit Tax
- A Covered Expatriate is a individual who meets ONE of THREE tests:
  - Average annual net income tax liability for the period of the 5 taxable years ending before the date of the loss of the United States citizenship is greater than $124,000 (indexed for inflation – currently $178,000)
  - Net worth of individual is $2MM or more
  - The individual fails to certify that he or she has complied with all US federal tax obligations for 5 years preceding expatriation

U.S. Expatriation Tax Consequences

- Mark-to-Market
- Deferred Tax Accounts
- Interests in Nongrantor Trusts
- Section 2801 – future gifts or bequests
- US situs assets post-expatriation