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The "Daily Plan-It™"

SHUMATE BROKERAGE CORP.

Volume 10, Issue 12 **6/12/2008**

Congress is Ending the Ultimate Estate Tax Plan and Leaving Us with the Question "Why Now?"

Congress has currently passed new legislation that will impact billions of US dollars. Over the years, many US citizens have chosen to renounce their citizenship and become "expatriates" by establishing domicile in countries that will tax their wealth in a more favorable manner. In short, Congress is shutting the door to what some call "the ultimate estate tax plan." Congress has repeatedly threatened to eliminate this ability and appears to make good on this threat.

Make the Money and Run

According to the Wall Street Journal, last year 470 Americans renounced their citizenship and moved abroad. The list of those who relinquished US citizenship included a London based entrepreneur and the daughter of an Iraqi private equity billionaire. (See Wall Street Journal article, New Law Makes Escape Tougher for Tax Exiles, Page D1, Wednesday, May 28, 2008.) Under the current law, a US citizen could leave the country, renounce their citizenship and over a 10-year phase out, substantially reduce their tax exposure. Basically they are able to redomicile themselves into a more tax favorable jurisdiction, thereby avoiding significant US taxes during life and after death. In short, Congress did not like the fact that the mega wealthy could make multimillions here and run to another country to avoid US estate taxes.

The New Law – a Tax Fence?

The new law has three major characteristics. For the sake of brevity, we have oversimplified the law, but the concept remains the same.

First, if a US citizen renounces their citizenship and leaves the US, they are liable for paying a tax equivalent to what they would have paid if they liquidated and sold all of their assets.

Second, in an interesting shift of strategy, Congress is taxing the US inheritors of wealth of former US citizens. For example, under the old law if a US billionaire expatriates to a new country, but his children stay in the US, there would be no tax consequence to the children. Under the new law, if the billionaire father expatriates, upon his death the children would pay a tax of up to 45% of what they inherit.

This is a major shift from the current approach, which was to tax the parent. Under the new law, it works like an inheritance tax. The children pay "inheritance tax" on the assets they receive from their expatriate parent.

Third, the law only applies to those with a net worth of $2 million and up. This is good news for those with assets below the 2 million dollar threshold. For those just above, it will create interesting valuation issues.

What does It Mean to Advisors?

First, we have to wait until the new law is actually signed by President Bush and goes into effect. In this world of increasing globalization, this law will create greater complexity for advisors in giving advice to clients on how to manage their assets and domiciles between different countries.

The second issue is more of a question; what happens in 2010 when the estate tax is scheduled to be repealed? Logically, why would Congress put a "tax fence" around the US to prevent the wealthy from leaving and taking their assets if the estate tax is repealed in two years? While we don't have an answer to this question, you could make the assumption the estate tax may be with us for some time to come. Is the new law telegraphing Congressional intent?